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ABSTRACT

The three reports in this publication examine the relationship between educators' benefits and state, local, and national economic conditions and policies. The reports had two goals: to encourage educators to consider economic factors in negotiating benefits and compensation, and to demonstrate that employee retirement and health benefits are a long-term commitment for both employer and employee. Decisions made when employees are 25 or 30 years old can influence their well-being 60 years hence. The first report, entitled "Benefits for Educators: What They Need, What They Get," evaluates major features of educators' health and retirement benefits in relation to both prevailing standards and educators' needs. The text is augmented by five data tables. The second report, "Educators' Benefits and State Economies," which is accompanied by several state and regional comparison tables, examines the relationship among state and local economies, government budgets, and the affordability and security of educators' benefits. The third report, "Educators' Benefits and the National Economy," examines the impact of the national economy and federal policies on educators' benefits. The findings of these reports suggest several issues for educators' consideration in evaluating the security and adequacy of their benefits, including inflation protection in retirement plans, retirement plan funding, investment of plan assets, and employee and retiree health care coverage. (MLH)

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BENEFITS AND THE ECONOMY

Implications for State Education Associations

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Executive Summary

The three reports that make up this publication were prepared for the National Education Association by Analytical Services, Alexandria, Virginia, with the advice and input of NEA's state and local associations. They were presented at the NEA 1990 Retirement and Benefits Forum as separate papers and are now combined into one volume. The reports examine the relationship between educators' benefits and state, local, and national economic conditions and policies. An action agenda is proposed.

The reports were prepared with two goals in mind. The first goal was to encourage educators to consider economic factors in negotiating benefits and compensation. Employee benefits are often based on tradition, competition, and similar factors. Economic trends that affect the adequacy of employee benefits should also play a role in this process.

The second goal was to demonstrate that employee retirement and health benefits are a long-term commitment for the employer and the employee. The employee receives benefits—or accrues future benefit rights in the case of retirement benefits—over a working career of 30 years or more. After retirement, the employee, surviving spouse, or dependents may receive employer payments for as long as 30 years. Thus, decisions on employee benefits made when an employee is 25 or 30 years old can influence his or her well-being 60 years hence. Decisions about the quality and affordability of educators' benefits thus cannot be made once and then forgotten. The employee benefit commitment must be continuously reaffirmed and monitored. Economic trends are an important tool for educators to use in this task.

The first report evaluates major features of educators' health and retirement benefits in relation to both prevailing standards and educators' needs. The second examines the relationship among state and local economies, government budgets, and the affordability and security of educators' benefits. The third report examines the impact of the national economy and federal policies on educators' benefits.

Educators' Benefits

Retirement and health benefits account for the largest share of employers' outlays for benefits. Most educators contribute to the cost of their retirement plans. Most are able to receive full retirement benefits before age 65. The share of preretirement income received by the typical retiree who is also covered by Social Security meets or exceeds generally accepted standards of adequacy.

For those who retire at relatively young ages, however, adequate income replacements rates must be reinforced by inflation protection as their benefits are exposed to inflation for a long period. About 20 to 30 percent of educators have retirement plans with full inflation protection, while 50 to 60 percent have partial protection. About 20 percent are in plans offering only ad hoc inflation protection. Most educators could thus see their retirement benefits significantly eroded by inflation.

Most teachers are covered under health care plans financed by their employers. Nearly two-thirds pay nothing toward the cost of their own coverage, but most educators must contribute to the cost of family coverage. Most educators are in health plans that limit the total benefits available. Teachers, in particular, are less likely than other groups to be in plans with annual limits on out-of-pocket expenses. Many educators are thus well protected against the more budgetable components of health care spending, but less protected against catastrophic medical expenses.

Fewer than half of educators are covered under health care plans that continue employer-financed coverage after retirement. Furthermore, the proportion covered after age 65 is lower than the proportion covered before age 65. Many educators will thus have to rely on coverage under Medicare, the health benefit component of Social Security, or protection through a spouse's plan in retirement.

Planning for educators' benefits should take into account the profession's demographic characteristics. Up to one million—or one in three—educators working in the year 2000 will have been hired in the late 1980s and 1990s. Younger employees have different compensation priorities from those raising families or those about to retire. The ability of school systems to recruit new employees and fulfill their commitments to their retirees will depend on the soundness of their planning today.

Benefits and State Economies

State and local government spending on education and on educators' compensation and benefits reflects taxpayers' ability and willingness to pay for education and other government services. Elementary and secondary education accounts for about $1 out of every $4 of state and local spending. In seeking to evaluate and expand the resources devoted to education, educators should assess not only actual spending but also state and local tax and spending capacity and effort. Many low-spending states, for example, exert high degrees of effort and thus may require supplemental funds to improve their educational systems.

The education profession faces a large number of retirements over the next decade. Consequently, educators should be concerned about the funding and security of their retirement pension and health benefits. Most educators' pension plans are adequately funded and monitored. A significant minority of both limited and general coverage plans operate on a pay-as-you-go basis, however, with little or no margin for economic downturns. Plans covering only educators tend to be less well funded than those that also include other public sector employees.

Many states use employee retirement plans for both short-term operating funds and long-term investment capital, however. An NEA survey of pension plans covering educators found that 12 states have delayed, deferred, or cancelled regularly scheduled pension plan contributions and 15 states have reduced contribution rates since 1985. The effects of such actions on benefit security need further study.

Most retiree health plans, in turn, are not funded at all. Consequently, as the educator force ages and retirements accelerate, many school systems could face problems in meeting their retiree health care commitments. Educators could face cost increases, benefit cutbacks, and even termination of retiree health care coverage unless these benefits are adequately secured.

One of the most important ways educators can ensure that their health and retirement benefits remain secure is to seek adequate disclosure of their employers' benefit commitments, liabilities, and resources. Ensuring such disclosure may require more intensive education efforts as well as statutory changes to require that needed information be produced.

Benefits and the National Economy

Federal aid to state and local governments has fluctuated with changing philosophies as well as federal budget constraints. Such changes have made it more difficult for localities to count on federal aid in their program planning. Education has probably been less affected by these problems than other functional areas, however, since federal grants for elementary and secondary education account for less than 7 percent of federal aid to state and local governments and less than 2 percent of state and local spending.

Federal tax policy affects state and local government spending and taxing decisions, as well as educators' compensation and benefits, in several ways. Federal tax act changes could discourage state and local governments from taxing, spending, and borrowing. These effects could take a long time to be felt, however, and could be offset by other factors such as the performance of the national economy.

Federal tax policy also regulates employee benefits. The debate over the federal tax treatment of employee benefits continues. Congress is debating taxing short-term investment gains in retirement plans and capping the employee tax exclusion for health care benefits. Limits on the tax benefits accorded to retirement plans could inhibit funding improvements in

public plans. Educators should be concerned about proposals to tax employer-provided health coverage because such taxes could force them to choose between benefit improvements and increased tax payments.

An Action Agenda

The findings of these reports suggest several issues that educators and NEA affiliates need to consider in evaluating the security and adequacy of their benefits:

Inflation protection in retirement plans. Retirement benefits that are adequate when the employee retires can be eroded by inflation. Many educators are in plans offering automatic inflation increases, but others are vulnerable.

Retirement plan funding. Advance funding of retirement liabilities reduces plan costs and increases benefit security. Funding can also influence the ability of plans to grant cost-of-living increases. Educators need to be sure that their plans are adequately funded. Actuarial assumptions used in plan funding need to reflect the long-term prospects of the economy and should not fluctuate in response to short-term changes.

Investment of plan assets. Most educators' plans are believed to be well managed, according to an NEA survey conducted for this report. Many plans are used by their sponsors for non-retirement purposes, however. Where social investing is practiced, educators need to be sure that plan returns and benefit security are not impaired.

Health care coverage. Most educators are well covered for the budgetable components of health care spending. Many face gaps in coverage for catastrophic health care expenses, however. Efforts to improve health care coverage for active employees should focus on these expenses. Furthermore, as health care costs increase, educators need to ensure that the benefits they value remain available and affordable.

Retiree health care coverage. Retiree health care coverage is becoming more costly over time. In response, some employers, public as well as private, have attempted to terminate or modify retiree health benefits, particularly upon the expiration of collective bargaining contracts. Educators need to carefully evaluate the adequacy, affordability, and security of these benefits.

Benefits for Educators: What They Need, What They Get

This report describes and evaluates the major features of retirement and health plans covering teachers and other educators. The report focuses on health and retirement benefits to which the employer contributes. Benefits that are entirely financed by employee contributions are generally not discussed, since they are not considered to be employer-provided. The report evaluates educators' benefits both in comparison with typical private sector benefits and in relation to the particular needs and circumstances of educators.

This assessment provides a foundation for the two companion reports in this series. The second report assesses the economic circumstances affecting employer decisions on spending for education and educators' compensation and benefits, and the third discusses the effect of the national economy on educators' benefits.

Two major data sources for this report are reports compiled by the U.S. Department of Labor, Bureau of Labor Statistics (BLS). *Employee Benefits in Medium and Large Firms, 1988* surveys the availability and features of employee benefit plans in private sector firms employing at least 100 workers. The survey represents benefits received by over 25 million employees. *Employee Benefits in State and Local Governments, 1987* surveys the availability and features of employee benefits in state and local government units employing at least 50 workers. The survey represents benefits received by over 12.5 million state and local government employees. The BLS data are reported both for all public employees together and separately for regular participants, teachers (at all levels), and police and firefighters. This volume also relies on Census data, BLS occupational projections, and other information sources. Various NEA reports have also provided information on the teacher force and educators' benefits.

This report begins with an overview of the demographic characteristics of educators, which influence their benefit needs. The major features of educators' retirement and health benefits are then evaluated, and benefit planning over the next decades, as large numbers of educators prepare to retire, is examined. The final section evaluates the report's policy implications for NEA and its members.

Who Are the Educators?

Who employees are influences the benefits they want and need. As benefits have become more available throughout the economy, the role of employee characteristics in determining the benefits employers offer is increasingly difficult to disentangle from the role of employer decisions. A growing body of economic literature suggests that better-paying jobs are more likely to offer benefits and that better-paid employees receive better benefits (Mitchell and Pozzebon 1987). It is thus difficult to tell whether employees

have certain benefits because they want them or because they come with a job that pays well.

Even with these limitations, certain clear demographic patterns emerge in evaluating employees' benefit needs. Both health and retirement benefits become more important to employees as they get older. Persons age 19 to 24, for example, are nearly one-third less likely to have employer-provided health care coverage, whether directly or as the dependent of an employee, than those age 25 to 54 (Short et al. 1988). Similarly, employees under age 25 are less than half as likely to be covered under an employer pension plan as the rest of the population (Woods 1989). Family status also influences benefit needs. Married adults are more than 25 percent more likely to have employment-related health care coverage than single or never-married persons (Short et al. 1988).

NEA's research on teachers shows that the current teacher population scores high on the major indicators of benefit needs (NEA 1987). The median age of teachers in the 1985-86 survey period was 41, compared with about 35 for the labor force as a whole. The age of the teacher force, combined with earlier retirement ages than in many other professions, makes adequate retirement and health benefits—both for active employees and for retirees—an urgent priority. The aging teacher force also suggests that up to half of all teachers will be retiring within the next 10 to 20 years, placing significant burdens on state and local government retirement systems.

Perhaps because they are older, teachers are more likely to be married than the rest of the population. Married teachers are often the family's principal earners, though many are in two-earner households (NEA 1987). Two-earner households can have an added measure of benefit security, particularly in retirement, since such couples often receive two or more pensions. More than two-thirds of teachers are women, however, and women teachers are less likely to be married than their male colleagues. Since women also tend to live longer than men, any gaps in benefit adequacy will affect them disproportionately.

Retirement and Health Benefits for Educators

Teachers and other public employees are generally well covered for health and retirement benefits. To evaluate benefit trends among educators, it is useful to compare public sector benefit packages with those offered to private employees in medium and large firms. How various employers meet the needs of their employees can help pinpoint both the strengths and the weaknesses in educators' benefits.

Overview

Retirement plans generally fall into one of two categories. Defined benefit plans offer a specified benefit based on some combination of the employee's earnings and length of service. In defined contribution plans, the employer's obligation is limited to making the contributions specified in plan documents.

Defined benefit plans are generally believed to offer participants better retirement security than defined contribution plans. In a defined benefit plan, the employer is committed to provide a specified benefit regardless of whether the employer has set aside enough assets to meet benefit promises. Benefits delivered in a defined contribution plan, in contrast, depend on the value of the assets in the participant's account at retirement. Early retirees, in particular, would tend to welcome the added security and predictability of a defined benefit plan.

Nearly all teachers in the school systems surveyed by the BLS are covered by retirement plans to which the employer contributes, as are most other public employees (Table 1). Most teachers and other public employees are covered under defined benefit plans. Teachers are significantly more likely to contribute to the cost of their plans, with 78 percent participating in contributory plans compared with 70 percent of other public employees.

Eight percent of teachers and 9 percent of other public employees are covered under defined contribution plans. Both groups of employees are less likely to be required to contribute to defined contribution plans than to defined benefit plans. A small proportion of employees are covered under both defined benefit and defined contribution plans.

Most teachers and other public employees are covered under health care plans financed in whole or in part by their employers. Nearly two-thirds pay nothing toward the cost of their own coverage, but most employees with health care coverage must contribute to the cost of family coverage.

Fewer than half of teachers or other public employees with health care coverage during their active years participate in plans that offer employer-financed coverage after retirement. Among teachers, 44 percent participate in plans that offer employer coverage for retirees younger than age 65 (Table 1). Among these employees, 54 percent are in plans that are fully

Table 1. Retirement and Health Benefit Coverage among Teachers and General Public Employees (as percent of all employees in group)

Benefit	Teachers	General public employees[a]
	%	%
Retirement plan[b]	99	97
Defined benefit	95	92
employer pays all	17	22
employer pays part	78	70
Defined contribution	8	9
employer pays all	5	4
employer pays part	3	5
Health care—active		
Employee coverage	95	94
employer pays all	61	59
employer pays part	32	34
Family coverage	95	94
employer pays all	27	25
employer pays part	65	68
Health care—retiree[c]	44	49
Younger than 65	44	49
employer pays all	54	48
employer pays part	45	51
65 or older	39	46
employer pays all	60	50
employer pays part	39	50

Source: U.S. Department of Labor (1988).

[a] Excluding police and firefighters.

[b] Detail may not add to total as some employees are covered by more than one plan.

[c] Employees with health care coverage who are in plans offering retiree coverage that is wholly or partly employer-financed. Plans that pay only for the retiree's share of Medicare Part B premiums are not included.

employer-financed. Only 39 percent of teachers participate in plans that promise employer-financed coverage after age 65.

Lower rates of employer-provided health care coverage for retirees age 65 or older probably reflect eligibility for Medicare, the health care component of Social Security, in many systems. Even Medicare leaves some important coverage gaps, however. Plans that offer coverage to retirees after age 65 are more likely to be fully employer-financed (60 percent of those covered) than before age 65 (54 percent). General public employees are somewhat more likely than teachers to retain health care coverage after retirement at any age, but are also more likely to contribute to their retirement coverage.

A Closer Look at Retirement Plans

Widespread coverage under defined benefit retirement plans suggests that most educators have secure retirement benefits. A closer look at the design features of public employee retirement plans suggests, however, that public employees also need to be sure that their plans are accumulating adequate assets to provide promised benefits when they come due. The second and third reports in this volume will return to the questions of plan funding and benefit adequacy.

Employee contributions

Teachers are more likely than either other public employees or private employees to participate in defined benefit plans that require employee contributions. Fewer than two-thirds of private employees surveyed by the BLS are covered under defined benefit retirement plans, but most of these plans are noncontributory (Table 2). In contrast, 82 percent of teachers and 76 percent of other public employees in defined benefit plans contribute to the cost of their plans.

Table 2. Features of Retirement Plans Covering Teachers and Other Employees

Plan feature	% of participants		
	Teachers	General public employees	Private employees
	%	%	%
Employee contributions required			
Defined benefit	82	76	7
Defined contribution	38	56	67
Normal retirement age[a]			
Younger than 65[b]	39	47	39
65[c]	4	10	41
Sum of age and years of service	11	8	12
No age requirements[d]	45	35	7
Cost-of-living adjustments			
Automatic	52	51	0
100% of inflation	21	34	*
At least one ad hoc increase in previous 5 years[f]	31	35	26

Source: U.S. Department of Labor (1988, 1989).

[a] Age at which unreduced benefit in defined benefit plans is available.
[b] Years of service requirements apply in most plans.
[c] Years of service requirements apply in some plans.
[d] Retirement based on years of service.
[*] Not applicable.
[f] 1982 to 1986 for public employees; 1983 to 1987 for private employees.

Funding in these plans thus depends critically on employee contributions.

Normal retirement age

The normal retirement age in a pension plan is the earliest age at which an unreduced benefit is available. Participants retiring earlier than this age generally receive a benefit that is reduced to reflect the fact that they will receive benefits over a longer retirement period. The normal retirement age is an important indicator of the generosity of plan benefits.

Teachers and regular public employees are more likely than private employees to be in plans with a normal retirement age under 65. Eighty-four percent of teachers and 82 percent of other public employees are in plans with a normal retirement age under 65 or based solely on years of service (calculated based on data in Table 2). By comparison, 46 percent of private employees participate in such plans. Among private employees, 41 percent of participants are in plans with a normal retirement age of 65.

Preretirement income replacement rates

Since pension benefits are intended to replace preretirement income, a pension plan's replacement rate is commonly used as a measure of benefit adequacy. This rate is the proportion of the retiree's final preretirement earnings that is represented by the retirement benefit in the year of retirement.

Retirees generally do not need their full preretirement income in retirement, since they tend to have smaller families, more consumer durables such as furniture, and lower job-related spending needs than working-age families. Taking these and other factors into account, pension benefits, combined with Social Security benefits, are generally designed to replace 70 to 90 percent of lower-income earnings and 40 to 60 percent of higher-income earnings for long-term (30-year) employees.

Teachers covered under both Social Security and employer plans meet these targets at most income levels. After 30 years of service, the typical teacher retiring at a hypothetical final pay of $35,000 will

Table 3. Average Replacement Rates in Defined Benefit Plans

Final earnings	Rate[a] Years of service 20	30
	%	%
Teachers		
Covered under Social Security[b]		
$15,000	74.7	89.8
25,000	67.0	82.2
35,000	58.3	73.9
Not covered under Social Security[c]		
$15,000	39.4	58.7
25,000	39.3	58.7
35,000	39.3	58.7
General public employees		
Covered under Social Security		
$15,000	74.9	90.5
25,000	67.5	83.4
35,000	59.1	75.3
Not covered under Social Security[c]		
$15,000	42.1	62.6
25,000	42.0	62.5
35,000	42.0	62.5
Private employees[d]		
$15,000	67.3	77.8
25,000	56.4	65.1
35,000	47.0	55.3

Sources: U.S. Department of Labor (1988, 1989)

[a] Annuity (plus Social Security, if applicable) as a percent of earnings in final year of work. Benefits are based on plan formulas applied to representative work histories and hypothetical final earnings levels.

[b] For pension formulas that are integrated with Social Security, the worker is assumed to have retired at age 65 and paid Social Security contributions for 40 years. For all other cases, benefits are based on years of service and earnings in the last year before retirement. Calculations do not include Social Security benefits employees may earn from other employment.

[c] Combined pensions and Social Security.

receive a retirement package—pension plus Social Security—replacing nearly 74 percent of final pay (Table 3). The typical general public employee will receive comparable benefits. These replacement rates may be from 15 to 20 percent higher than a similarly situated private employee would receive from the same sources, though many private employees would also receive benefits from supplemental defined contribution plans. Replacement rates in plans for teachers and regular public employees thus provide at least some protection against their longer retirements and potential inflation exposure.

More than one-third of teachers and more than one-fifth of regular public employees are not covered under Social Security. These employees can expect leaner retirement benefits, amounting to 40 percent of final pay after 20 years of service and about 60 percent of final pay after 30 years (Table 3). For retirees covered by both Social Security and employer plans, combined replacement rates are higher at lower levels of income. This feature reflects the fact that employees with lower preretirement earnings need a higher replacement rate to maintain an adequate standard of living in retirement. In contrast, replacement rates in freestanding plans are similar at all income levels.

Some educators in systems that do not participate in Social Security will qualify for benefits on the basis of outside employment, but these numbers may not be very high. In 1986, for example, fewer than one in five teachers reported outside summer employment and fewer than one in seven reported outside employment during the school year (NEA 1987). Consequently, educators without Social Security coverage should be especially concerned with benefit design.

replacement rates, and inflation protection in their retirement plans.

Cost-of-living adjustments

Because teachers and other public employees are able to retire earlier than private employees, their benefits may be exposed to the effects of inflation for a longer period. These effects can be significant. The average person retiring at age 62 in 1986 could expect to live nearly 19 more years. At 4 percent annual inflation, which is considered moderate, the retiree's pension benefit would have declined to half its original purchasing power within 18 years. Even with cost-of-living adjustments worth half the inflation rate, the benefit would lose 30 percent of its original purchasing power within 18 years. Thus, assuming even moderate inflation, an adequate, or even generous, retirement benefit could be eroded significantly just when the retiree may be facing significant medical and personal costs, such as nursing home care.

Postretirement inflation protection varies among public employees. Over 80 percent of both teachers and regular public employees participating in defined benefit plans are in plans offering some inflation protection, compared with only 26 percent of private employees (Table 2). However, only half of public sector participants are in plans with automatic inflation adjustments, and about one-fifth of teachers and one-third of public employees are in plans offering automatic adjustments that fully reflect inflation. The remainder with automatic adjustments receive increases equal to some fraction of inflation.

Plans without automatic inflation increases often provide occasional or ad hoc increases. These increases are generally not scheduled and may not fully reflect inflation. The increase offered may differ according to the employee's year of retirement, reflecting the fact that more recent retirees have suffered less from inflation.

Ad hoc inflation increases are sometimes awarded based on the plan's funding status. The funding status is measured by the ratio of plan assets to accumulated benefit promises. Plan income resulting from better-than-expected investment performance, for example, is often used for inflation increases. Economic events can also reduce plan income, however. Conversely, poor investment performance, more retirements than projected, or other adverse plan experience may forestall ad hoc inflation increases.

About one-third of teachers and public participants and just over one-quarter of private participants are in retirement plans that awarded at least one ad hoc cost-of-living adjustment in the five years before the BLS surveys were conducted. As many as half of private defined benefit plan participants are also covered by some type of defined contribution plan. Such plans can offer supplementary inflation protection since their yield would generally reflect prevailing inflation rates.

A Closer Look at Health Care Plans

Two commonly used measures of health benefit adequacy are employee costs and limits on expenses and benefits. Educators tend to be well protected for health care expenses that can be budgeted by the average household. Households with unusual, or catastrophic, health care expenses could, however, find that their benefits fall short of their needs.

Employee contributions

Many employers require employee contributions for health care coverage to encourage greater cost-consciousness in health care use among their employees. Employers often impose higher employee contributions for more generous plans.

Private employers are more likely than public employers to require employee contributions. Among private employees, 44 percent contribute to the cost of their own health care coverage and 64 percent contribute to the cost of family coverage (Table 4). By comparison, 37 percent of teachers and 32 percent of regular public employees contribute to the cost of their own coverage. Public employees are significantly more likely to contribute to the cost of family coverage than are private employees, however. Where employee contributions apply, all three groups pay similar monthly amounts for individual coverage, while public sector employees tend to pay more toward family coverage (Table 4, notes).

Deductibles

To limit plan costs and encourage cost-consciousness in health care use among employees, most plans impose deductibles. The deductible is the amount of medical expenses the employee must pay in full before the plan will begin payments. After the deductible is met, the employee is responsible for a share of covered expenses incurred, typically 20 percent. Employee payments beyond the deductible are called coinsurance payments.

Deductibles are nearly universal in both public and private plans, but deductibles in public plans tend to be lower. Over 60 percent of both teachers and regular public employees are covered in plans with

Table 4. Features of Health Care Plans Covering Teachers and Other Employees

Plan feature	Percent of participants		
	Teachers	General public employees	Private employees
	%	%	%
Employee contributions required			
Employee coverage[a]	37	32	44
Family coverage[b]	73	70	64
Deductible required[c]	97	96	95
$100 or less	64	60	51
More than $100	31	36	40
Maximum limit on out-of-pocket expenses	75	80	78
Maximum limit on benefits	80	84	77
Lifetime only[d]	68	72	71
Annual or disability only	3	2	4
Both limits apply	8	9	2
Retiree coverage[e]	44	49	45
Flexible benefit and/or reimbursement account[f]	11	8	13
Flexible benefit with reimbursement	8	4	5
	2	1	4
Reimbursement account freestanding	5	4	12
	3	3	8

Sources: U.S. Department of Labor (1988; 1989).

[a] Average $16 per month for public employees, $19 for private.
[b] Average $72 per month for public employees, $60 for private.
[c] Per insured person; family deductibles may differ. Some plans determined deductibles based on other than dollar amounts.
[d] Average limit is $865,000 in public sector plans and $760,000 in private plans.
[e] Excludes plans in which employee pays entire cost of plan.
[f] Detail does not add to totals as employees may participate in more than one type of plan.

deductibles of $100 or less, compared with about half of private employees (Table 4).

Limits on out-of-pocket expenses

To protect employees with extraordinary health care expenses, most plans limit the out-of-pocket expenses an employee can incur yearly, paying 100 percent of all costs incurred after the limit is reached. Teachers are slightly less likely than either general public employees or private employees to be in plans with such limits. Three-quarters of teachers, 80 percent of general public employees, and 78 percent of private employees are protected against major expenses (Table 4).

Teachers in plans with out-of-pocket expense limits, in turn, tend to have lower limits, and thus more protection against catastrophic medical costs, than either regular public or private employees. Individual caps average $800 in public plans and $957 in private plans. Family caps average $1200 for teachers, $1400 for regular public employees, and $2004 for private employees.

Limits on benefits

Limits on expenses protect the participant from high expenses; limits on benefits protect the plan. Teachers are more likely than private employees, but less likely than general public employees, to be in plans that limit benefits.

Most plans that limit benefits impose lifetime limits. The average lifetime limit on benefits is $865,000 in public sector plans and $760,000 in private plans. Among teachers, 76 percent are in plans with lifetime limits, compared with 81 percent of general public employees.

Retiree health care coverage

Fewer than half of all active employees are covered under health care plans that offer employer-financed coverage after retirement (Table 4). Teachers are somewhat less likely than either general public employees or private employees to be in plans with such coverage. Some teachers may also be covered under health plans that offer fully employee-financed coverage after retirement; data on such plans are not available.

Retiree health care coverage is particularly important for those who retire before becoming eligible for Social Security or who are not covered under Social Security. Data are not available on how many teachers without retiree coverage are covered under Social Security through their principal employment, through outside employment during the summer or the school year, or as spouses of covered workers.

Flexible benefit plans

Employers are becoming increasingly interested in flexible benefit plans. "Full" flexible benefit plans, also known as cafeteria plans, allow employees to choose between two or more types of benefits, such as health, life, or disability insurance. Reimbursement accounts provide employer contributions, employee pretax contributions, or both for expenses not covered under the basic benefit plans. These accounts may be freestanding or offered as part of a flexible benefit plan.

These plans can help employers accommodate the benefit needs of different types of households without increasing total benefit outlays. Two-earner households can choose child care instead of duplicative health care coverage, for example, while older employees can choose retirement savings instead of life insurance. These plans can also help cushion the impact of increased contribution requirements on employees by providing for pretax payment of employee contributions.

Flexible benefit plans can also complicate an employer's benefit decisions. Most employers adopt flexible benefit plans to encourage employees to enroll in less generous health plans. When those who use less health care enroll in different plans from high users, however, the cost of covering high users can spiral. This phenomenon, known as adverse selection, can result in more expensive or less adequate coverage for the least healthy members of an employee or retiree group.

Flexible benefit plans are more prevalent among private than among public employers. Among private employees, 13 percent are eligible for one or both types of plans, compared with 11 percent of teachers and 8 percent of general public employees (Table 4). Among teachers, flexible benefit plans are the more common plan available, while private employees are more likely to be eligible for reimbursement accounts. Both types of plans could become more common as employers endeavor to maintain current benefits and provide new benefits such as insurance for long-term care in the face of rising health care costs.

Planning for the Future: Educators in the Year 2000

A key element of planning for educators' benefits is projecting the number of active and retired educators. Such projections are particularly critical to ensuring that adequate funds are on hand to pay retirement benefits when they come due.

Between 1976 and 1986, the proportion of teachers in their 20s dropped by more than 70 percent, while the proportion in their 40s and 50s increased by nearly 50 percent (NEA 1987). More than one in five teachers were age 50 or older in 1986. Most of this group will probably retire by the mid-1990s.

The BLS forecasts the size of the future labor force as well as employment in specific occupations under low, moderate, and high growth assumptions. Under the moderate forecast, the total number of preschool, kindergarten, elementary, and secondary school teachers will increase by about 500,000, or over 18 percent, between 1988 and 2000 (Silvestri and Lukasiewicz 1989). Growth patterns will vary among the major segments of the teacher force:

- The fastest-growing segment of the teacher force will be preschool teachers, with higher growth rates than projected for other educators or for the U.S. labor force in general (Table 5). Preschool teachers accounted for just over 8 percent of the teacher force in 1988, however, so their growth is occurring from a smaller base.
- Employment for kindergarten and elementary school teachers, who accounted for nearly 50 percent of teachers in 1988, is expected to grow at rates roughly comparable to those of the rest of the work force.
- Employment for secondary school teachers, who account for about 42 percent of the teacher force, will grow 14 to 25 percent during the forecast period. These rates are significantly higher than those projected for either the teacher force or the work force as a whole.

Table 5. Employment Growth to the Year 2000

	Projected growth: 1988-2000		
	Low	Moderate	High
	% change in employment		
All occupations	8	15	22
Teachers, librarians, and counselors	10	16	21
Preschool teachers	22	30	33
Kindergarten and elementary school teachers	10	15	21
Secondary school teachers	14	19	25
New jobs for teachers, librarians, and counselors as % of all new jobs	6	5	4

Source: Silvestri and Lukasiewicz (1989), 42-65.

The educator force is not expected to grow at the same rate as the rest of the work force. New jobs for teachers, librarians, and counselors will range from 6 percent of all new jobs economy-wide under the low growth forecast to 4 percent under the high growth forecast (Table 5).

The BLS forecasts changes in the total size and makeup of the work force and thus does not take separate account of the replacement recruiting that will be made necessary by retirements and attrition. To predict the total number of new teachers that will be needed between the late 1980s and the turn of the century, it is thus necessary to add replacement recruiting to the 500,000 or so net new teachers that will be needed under the BLS forecasts.

Based on NEA research, we project that replacement recruiting will be roughly equal to new recruiting between the late 1980s and the year 2000. In total, as many as 1 million new teachers may be needed between now and the turn of the century. Thus, of the 3.26 million teachers the BLS projects will be working in 2000, about 1 in 3 will have been hired during the late 1980s and the 1990s. Most of these teachers will be in their 20s and early 30s. By comparison, only 11 percent of teachers were under age 30 in 1986 (NEA 1987).

Projections of replacement recruiting are necessarily "soft," or subject to error, since they are based solely on the age distribution of teachers rather than on their plans to retire. These projections do suggest, however, that there could be some important differences in the needs of teachers in the year 2000. As the teachers who are today in their late 30s or 40s are planning to retire, a large share of the teacher force will be composed of younger teachers. With families and mortgages to support, younger employees are more concerned with current cash compensation than with retirement benefits and could resist the increased retirement plan contributions that many underfunded plans may need to implement.

Pension and retiree health plans that are not adequately funded must rely on current employer and employee contributions to pay retiree benefits. School systems with such plans could be hard pressed to both offer the salaries needed to attract new educators and to honor their benefit commitments to retirees.

Conclusions

As employees age, their needs and concerns turn increasingly toward the adequacy and security of their retirement and health benefits. Teachers score particularly high on important indicators of benefit needs, such as age, gender, and family status.

Most educators receive adequate retirement and health benefits. Significant unmet needs remain, however. Most public employee retirement plans replace an adequate share of preretirement income by prevailing standards, particularly if the participant also has Social Security coverage. Educators, and particularly teachers, are able to retire earlier than private employees, however. Over a long retirement, even an adequate retirement benefit can be eroded by inflation.

Most public employee retirement plans have limited protection against inflation.

Public employees' health care coverage also compares well with private sector standards. However, educators tend to have better coverage for the easily budgetable components of health care spending, such as employee contributions and deductibles, than for the kind of catastrophic medical expenses that can devastate a family's finances. Improvements in medical plans need to focus on limiting employees' out-of-pocket expenses and raising plan benefit limits.

Affiliates also need to be concerned about their health care coverage in retirement. A majority will not receive employer-financed coverage and thus must rely on Medicare, privately purchased coverage, or coverage through a spouse's employment. Retiree health care coverage also takes on particular importance for those who may retire before becoming eligible for Social Security and Medicare benefits.

The major sources of information on plan provisions are the various documents employers distribute to employees. The required disclosures to employees can vary significantly by state, however. The Employee Retirement Income Security Act (ERISA) prescribes the information that employees must receive about their plans. In states where information disclosed to employees is not adequate, affiliates need to lobby for expanded information about plan benefits and provisions.

Future trends in the educator work force will influence the affordability to employers of both promised benefits and benefit improvements. As many as one million new teachers may be needed between now and the year 2000 to accommodate work force growth as well as recruiting to replace retirees. Younger employees have different priorities in their compensation package than those approaching retirement. The ability of school systems to meet the needs of active employees as well as retirees will depend on the soundness of their planning today.

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Educators' Benefits and State Economies

This report examines state and local government spending on education, educators' compensation and benefits, and other government functions. National trends in employee benefits and work force demographics, examined in the first report of this series, can help establish guidelines for evaluating benefits offered in individual school systems. Elementary and secondary education in the United States is primarily a state and local government function, however. Thus, educators' compensation and benefits will depend on what states and localities are willing and able to spend, or their economic capacity.

State and local economic conditions influence the adequacy and security of educators' benefits. A comprehensive review of the interactions among these factors and their influence on government spending is beyond the scope of this report. It is possible, however, to gain important insights into how citizens make decisions about government spending in general and education spending in particular by examining key measures of education needs, government revenue sources, and budget priorities.

A major source of data for this report is *Significant Features of Fiscal Federalism*, published by the Advisory Commission on Intergovernmental Relations. The ACIR publishes detailed information on state and local government spending, revenues, and other characteristics. This report also uses the Bureau of the Census's *Employee Retirement Systems of State and Local Governments* to evaluate the funding status and other characteristics of public employee retirement systems. Various NEA reports provide information on the teacher force and educators' benefits. Other government and private sector data sources are also used.

This report begins with an examination of the factors that determine a state's need for education resources. Measures of the resources a state has available to spend on education and other public programs are examined as well as state and local government spending on education and other functions. The finance and management of public employees' benefit programs are then evaluated. Finally, the report's policy implications for NEA and its members are discussed.

Education Needs

A fundamental measure of a community's need for education resources is the share of its population that is of school age. Nationwide, just under one in five persons was between the ages of 5 and 17 in 1987 (Table 1). The share of the population in this age group ranged from 26.5 percent in Utah to 15.7 percent in Florida, for a difference of nearly 70 percent.

Many areas of the country with a relatively large school-age population are growing rapidly. Population growth is both a source of new education demand and a resource to meet this demand. New residents represent new workers, jobs, and consumer spending. As

Table 1. Population Features by State and Region

State and region	Population 1988 (000)	Growth 1980-1988 (%)	% Age 5-17 (1987)
United States	**245,807**	**10.7**	**18.6**
New England	12,962	5.5	16.9
Connecticut	3,233	4.6	16.9
Maine	1,205	8.2	18.5
Massachusetts	5,889	2.7	16.2
New Hampshire	1,085	21.6	18.0
Rhode Island	993	4.3	16.6
Vermont	557	11.8	18.4
Mideast	**43,530**	**2.8**	**17.3**
Delaware	660	10.9	17.9
District of Columbia	617	−7.2	14.5
Maryland	4,622	10.5	17.5
New Jersey	7,721	5.0	17.2
New York	17,909	1.3	17.5
Pennsylvania	12,001	1.0	17.3
Great Lakes	**42,210**	**1.4**	**19.2**
Illinois	11,614	1.8	18.8
Indiana	5,556	1.6	19.5
Michigan	9,240	0.2	19.5
Ohio	10,855	0.5	19.1
Wisconsin	4,855	4.5	19.0
Plains	**17,759**	**4.1**	**18.7**
Iowa	2,834	−2.9	18.9
Kansas	2,495	6.8	18.5
Minnesota	4,307	7.3	18.6
Missouri	5,141	5.2	18.4
Nebraska	1,602	2.4	18.9
North Dakota	667	2.5	19.6
South Dakota	713	3.5	19.5

State and Region	Population 1988 (000)	Growth 1980-1988 (%)	% Age 5-17 (1987)
Southeast	**58,674**	**14.8**	**18.8**
Alabama	4,102	7.0	20.1
Arkansas	2,395	6.8	19.9
Florida	12,335	35.5	15.7
Georgia	6,342	19.8	20.2
Kentucky	3,727	3.2	19.8
Louisiana	4,408	8.3	20.8
Mississippi	2,620	5.3	22.1
North Carolina	6,489	12.7	18.5
South Carolina	3,470	14.0	20.0
Tennessee	4,895	9.1	19.0
Virginia	6,015	14.1	17.6
West Virginia	1,876	−2.4	19.7
Southwest	**25,079**	**24.3**	**20.3**
Arizona	3,489	38.7	18.7
New Mexico	1,507	21.7	20.8
Oklahoma	3,242	11.1	19.4
Texas	16,841	24.7	20.7
Rocky Mountain	**7,278**	**16.2**	**21.1**
Colorado	3,301	19.3	18.4
Idaho	1,003	10.1	22.2
Montana	805	2.9	19.8
Utah	1,690	23.5	26.5
Wyoming	479	10.6	21.4
Far West	**38,405**	**22.8**	**18.2**
California	28,314	24.0	18.1
Nevada	1,054	46.6	17.5
Oregon	2,767	9.9	18.2
Washington	4,648	19.5	18.2
Alaska	524	29.4	21.3
Hawaii	1,098	17.8	18.2

Source: Author's calculations based on ACIR (1989) and U.S. Department of Commerce (1989b)

local economies expand, their ability to meet their social needs also grows. The Southwestern and Rocky Mountain regions, which grew more rapidly during the 1980s than the rest of the nation, also have a relatively large student population. In New England, by contrast, only about one in six persons is a school-age child, and population grew at about half the national rate during the 1980s.

Not all areas with large student populations are growing, however. The Great Lakes states have a larger share of children than the national average, but their total population grew by only 1.4 percent during the 1980s. To the extent that population growth represents an added resource, these states are likely to face a higher relative burden in educating their children.

Measuring State Resources

A state or locality's economic capacity is sometimes measured by its budget surplus or deficit. Forty-six states and many localities are required by statute, constitution, or both to balance their operating budgets. Operating budgets cover spending for current services. Capital projects, such as new facilities, are commonly financed by issuing debt. Balancing operating budgets can sometimes be a strain for state and local governments, since it requires accurately forecasting both revenues and expenditure needs. When operating

deficits threaten, it is common for states and localities to cut spending or raise taxes, even after enacting their budgets.

A government's budget position is only a partial measure of its underlying economic capacity, however. A budget deficit or surplus does not measure what a state or locality can afford to spend on desired services. Rather, the deficit or surplus measures the relationship between the services the citizens want to receive and what they are willing to or able to spend. A state or locality with a high demand for public services but a low willingness to pay taxes will face budget problems even if its citizens have the economic capacity to pay for the services they demand. A low-capacity state, on the other hand, may keep its budget in balance by providing fewer services.

States and localities vary widely in their needs, their resources, and their willingness to spend money on government functions, including education.[1] These differences reflect a wide range of factors, including income and other revenue sources, political structure and attitudes, private sector activity, and even geography and demography.

A state's income and other resources influence both its need for government services and what it can and wants to pay for them. Private sector resources and activity can also influence government spending by providing alternative sources of services. For example, Massachusetts, with a large number of private colleges and universities, devotes 5.8 percent of state and local spending to higher education, while Indiana and Wisconsin, with large state systems, spend nearly twice as much.

Finally, unique features of the state will influence how its money is spent.[2] Wyoming, the most sparsely populated of the continental United States, spends nearly twice as much on highways as the national average, while New Jersey, the nation's most densely populated state, spends much less than the national average. Urbanized states, in turn, spend more on police, fire, parks, and recreation than more rural states.

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[1] While elementary and secondary education is generally financed by local governments, states are used as the unit of measure in this report largely to limit data needs. School spending can and does vary widely within states.

[2] Some of the comparisons drawn below exclude Alaska, Hawaii, and the District of Columbia, even though data for these areas are presented in most tables in this report. These areas have such specialized government and financial circumstances that they can distort many trends and comparisons.

What the citizens of any state or locality can spend on education or any other goernment function depends first of all on the resources from which they can draw, or their ability to pay taxes. Most people first think of income as an index of what people can afford, and, indeed, most taxes are paid using current income. Income is not the only state and local tax base, however. Individual and corporate income taxes together accounted for only 15.5 percent of state and local government revenues in 1987, placing them second to property taxes and just ahead of sales and gross receipts taxes.

To take account of the various tax bases state and local governments use, we could add up the dollar value of taxable resources—income, property, sales, natural resources—in each state and locality. This would be a very large, but not very enlightening, number. It would not take account of differences in the mix of tax bases across jurisdictions; adding property values to sales transactions, for example, would be like adding apples and oranges. Furthermore, simply adding up potentially taxable resources would not take account of differences in the way various tax bases are treated. Property tax rates, for example, are set differently from income tax rates. Voters in different areas also have different perceptions of appropriate government roles and how "large" government should be. Such a resource total would not reflect these differences.

Tax capacity and tax effort are two techniques that have been developed to reflect the affordability and relative burden of providing government services across jurisdictions. Constitutional and statutory spending and debt limitations also influence what different states and localities can afford.

Tax Capacity

Tax capacity is measured by a jurisdiction's endowments of income, wealth, and natural resources. These endowments determine the government services its citizens want and can afford.

Determining tax capacity begins with a measure called the Representative Tax System (RTS), developed by researchers at the U.S. Advisory Commission on Intergovernmental Relations (ACIR). The RTS is a set of national average state and local tax rates that are applied to 26 commonly used tax bases. To arrive at a state's tax capacity, the RTS is applied to each state's mix of resources. The resulting total is the amount of revenue the state would raise if it both used these tax bases and applied the national average tax rates to them. To compare tax capacity among states,

Table 2. Tax Capacity, Tax Effort, and Income by State, 1986

State and region	Tax capacity	Tax effort	Per capita income[a]
United States (average)	**100**	**100**	**100 ($14,608)**
New England			
Connecticut	135	94	134
Maine	95	99	88
Massachusetts	124	103	120
New Hampshire	119	62	114
Rhode Island	92	111	100
Vermont	99	91	91
Mideast			
Delaware	121	81	105
District of Columbia	122	143	128
Maryland	108	99	116
New Jersey	121	103	129
New York	107	152	115
Pennsylvania	90	101	98
Great Lakes			
Illinois	96	106	106
Indiana	87	94	90
Michigan	96	118	101
Ohio	91	103	95
Wisconsin	86	134	95
Plains			
Iowa	84	113	92
Kansas	96	96	99
Minnesota	102	108	103
Missouri	93	82	95
Nebraska	91	96	93
North Dakota	94	89	85
South Dakota	78	95	81
Southeast			
Alabama	74	86	77
Arkansas	78	91	76
Florida	105	77	100
Georgia	94	89	92
Kentucky	76	89	77
Louisiana	90	91	77
Mississippi	65	97	68
North Carolina	88	92	85
South Carolina	79	94	77
Tennessee	84	84	82
Virginia	101	85	106
West Virginia	76	98	72
Southwest			
Arizona	99	99	94
New Mexico	91	88	78
Oklahoma	98	85	84
Texas	104	79	93
Rocky Mountain			
Colorado	117	83	104
Idaho	77	90	77
Montana	88	90	80
Utah	80	107	75
Wyoming	151	117	87
Far West			
California	118	95	115
Nevada	147	65	106
Oregon	93	98	91
Washington	98	103	102
Alaska	177	168	126
Hawaii	113	105	101

Source: ACIR (1989).

[a]Per capita income in 1986 as a percent of average U.S. per capita income.

each state's per capita tax capacity is divided by the per capita average for all states, with the index for the average set at 100.

For education purposes, more limited measures of tax capacity may be useful. For example, the average value of assessed property per school pupil can provide a measure of a locality's capacity to finance education. Areas with low values of this variable may be able to make a case for new revenue sources or aid from higher levels of government.

Tax capacity ranges from a low of 65 percent of the national average in Mississippi to a high of 177 percent in Alaska (Table 2). Tax capacity is a relative measure. If one state raises its income tax rates, for example, the national average rate would also rise, raising each state's potential to raise taxes as well.

High-income states generally have higher tax capacity, but this relationship is not uniform. Certain high-capacity states, such as Connecticut and New York, also have high incomes. Other states have high tax capacity because they have other taxable resources. Wyoming, for example, is a high-capacity state with a per capita income below the national average; its tax capacity is based on minerals and other natural resources. Similarly, while Alaska is a high-income state, its relative tax capacity is higher than its relative income because its tax capacity also reflects its natural resources.

Tax Effort

Tax capacity measures what jurisdictions could spend, but not what they are willing to spend. What taxpayers are willing to spend is measured by tax effort. Tax effort, or willingness to pay, is the ratio of actual to potential revenues. Tax effort reflects the interaction of each state's political process with its resources. Tax effort thus incorporates a measure of both ability and willingness to pay. As with tax capacity, each state's tax effort is measured against the national average.

To see how the concepts of tax capacity and tax effort are used, consider the following example. In 1986, Maine and Tennessee each had roughly $25.0 billion in locally assessed property, both residential and commercial. At any given property tax rate, therefore, the property tax capacity in these two states was virtually equal. Maine local governments collected about $554 million in property taxes in that year, compared with $1.13 billion in Tennessee. Tennessee and Maine thus had equal property tax capacity, but Tennessee's property tax effort was more than twice that of Maine.

Higher tax capacity generally does not mean higher tax effort. States with larger tax bases can often provide the same or greater services with less effort than states with fewer resources. Mississippi, with the nation's lowest tax capacity, taxes itself about as heavily as the national average (Table 2). New Hampshire, on the other hand, taxes itself 62 percent as heavily as the national average, but has 119 percent as much tax capacity as the average.

Tax effort reflects political climate as well as resources. It is thus not surprising that there is not a close relationship between income and tax effort. Connecticut had the nation's highest per capita income in 1986, for example, but its tax effort was 94 percent of the national average (Table 2). Most of the Southeastern states have lower incomes than the national average, but their tax efforts are generally within 10 percent of the national average.

Spending and Debt Limitations

Since the enactment of Proposition 13 in California more than a decade ago, the number of state and local government tax and spending limitations in force has grown dramatically. Thirty-three states have enacted 46 different types of state and local government tax and spending limitations since 1978 alone, compared with a total of 53 limitations up to that time.

Limits on state and local spending take a variety of forms. Of particular concern to education finance are limits on property taxes, as the property tax constitutes 46 percent of local government own-source revenues, and education accounts for nearly 40 percent of local spending (ACIR 1989). Thirty-nine states impose at least one type of limit on local property tax rates or levies, and many impose more than one type of limit (Table 3). Property tax limits are the least prevalent in New England, but are widespread in the rest of the nation. Five states limit property assessment increases. Seven states limit local government general revenues and another six limit local general spending. State-imposed limits on local spending and revenues are most prevalent in the Mideast and Plains states.

While education is financed primarily by localities, local governments receive one-third of their income from states. Thus, limits on state spending will also affect localities. Twenty states have enacted limits on state spending, revenues, or both since 1976 (Table 3). These limits generally tie state spending and revenue growth to income growth within the state. Most states with state limits are in the western part of the country.

State and Local Spending in Perspective

Tax capacity and tax effort indicate, respectively, how much money a jurisdiction could raise and does raise. Local resources devoted to education spending also depend on local spending priorities. State and local governments perform five major functions: education, public welfare, health and hospitals, highways, and police. While all state and local governments perform these functions, the share of resources they devote to them varies widely.

This section discusses the major variations in education spending among the states and some of the most important factors affecting educators' compensation and benefits in particular.

Elementary and secondary education is the single largest state and local spending category, accounting for an average of nearly $1 out of every $4 in direct spending (Table 4). State and local government spending on education ranges from 16.8 to 28.6 percent of state outlays.

Spending on other major government functions displays wider variation. Higher education accounts for a national average of 9.2 percent of state and local spending, with individual states ranging from 4.3 to 14.9 percent. Spending on public welfare, health and

Table 3. State and Local Government Tax and Expenditure Limitations

	Limits on Localities		
	Property tax[a] (# of limits)	Other[b]	Limits on states[c]
New England			
Connecticut			
Maine			
Massachusetts	1		x
New Hampshire			
Rhode Island	1		x
Vermont			
Mideast			
Delaware	2	R	x
District of Columbia			
Maryland		A, R	
New Jersey	1	S	x
New York	1	A	
Pennsylvania	1		
Great Lakes			
Illinois	2		
Indiana	1		
Michigan	3		x
Ohio	2		
Wisconsin	1		
Plains			
Iowa	1	A	
Kansas	1	S	
Minnesota	2	R, S	
Missouri	1	R	x
Nebraska	1	R	
North Dakota	1		
South Dakota			
Southeast			
Alabama	2		
Arkansas	2		
Florida	2		
Georgia	1		
Kentucky	2		
Louisiana	2		x
Mississippi	2	R	
North Carolina	1		
South Carolina			x
Tennessee			x
Virginia			
West Virginia	2		
Southwest			
Arizona	1	A, S	x
New Mexico			
Oklahoma	2		x
Texas	1		x
Rocky Mountain			
Colorado	2	S	x
Idaho	2		x
Montana	1		x
Utah	1		x
Wyoming	1		
Far West			
California	1	A, S	x
Nevada	3		x
Oregon	1	A	x
Washington	3	R	x
Alaska	2		x
Hawaii	—	—	—
States with limits	39	15	21

Sources: ACIR (1987, 1989).

[a] Category includes overall tax rate limits, specific tax rate limits, and tax levy limits.
[b] A = limits on assessment increases; R = limits on general revenues; S = limits on general spending.
[c] Enacted since 1976; may include limits on state revenues, expenditures, or both.

hospitals, highways, and police displays similar relative variation between the highest and lowest states. These figures suggest that there is no typical state budget and thus no single norm to which all governments can be held.

What the States Spend on Education

Education spending can be measured in different ways. In this section we consider these measures and examine the major factors that distinguish high- and low-spending states.

There are several measures of the resources a community devotes to its schools and the value it places on education. No measure is complete in itself; each sheds a different light on the community decision-making process.

Education spending as a share of personal income measures the effort a nation, state, or community devotes to education. This measure can suggest how much people value public education relative to the other private goods and services on which they can spend their income.

Table 4. State and Local Government Spending by Function (as percent of total spending by each state)

Function	High state	Low state	National average
	%	%	%
Elementary and secondary education	28.6	16.8	23.9
Higher education	14.9	4.3	9.2
Public welfare	17.8	5.2	12.2
Health and hospitals	16.0	2.5	8.7
Highways	14.9	4.5	8.0
Police	5.3	1.8	3.8
All other functions[a]	56.1	24.8	34.3
Government spending as percent of state personal income	55.1	14.5	18.7

Source: Author's tabulations based on ACIR (1989).

Notes: Totals include state and local government direct spending from all revenue sources. High and low states exclude District of Columbia; national average based on 50 states plus District of Columbia.

[a] Category includes state-local and local-state intergovernmental transfers. These transfers totaled 0.4 percent of state and local government spending in 1987.

Average spending per pupil, perhaps the most commonly used measure of education spending, tells us the dollar value of the resources devoted to education in each state. It does not necessarily reflect the affordability or the purchasing power of education spending.

Education as a share of government spending suggests how people value education compared with other government services and programs.

Teachers' salaries relative to prevailing income levels indicate the value a community places on teachers' work compared with other occupations.

Education as a Share of Personal Income

Comparing education spending to personal income indicates the degree of effort devoted to education in each state. This figure can be used as a measure of the affordability of education spending in various localities, much as tax effort measures the affordability of all government spending. Nationally, state and local spending on eucation accounts for 4.4 percent of personal income (Table 5).

As with tax effort, education effort can be inversely related to a state's resources. Connecticut and New Jersey, the two highest-income states in the nation, both spend less by this measure than the typical southeastern state, where incomes tend to be lower than the national average. New York, on the other hand, is an affluent state (eighth in the nation) that also spends a larger share of income on education than the national average. Because of such variations, there is no one "right" share of personal income that states should spend on education.

Average Spending per Pupil

Average spending on education is higher in high-income states. Four of the five highest-spending states are in New England and the Mideast (Table 5). These are also higher-income regions.

High-spending states are not always high-effort states. Of the five highest-spending states—Connecticut, Massachusetts, New Jersey, New York, and Wyoming—only Wyoming and New York spend a larger share of income on education than the national average.

Spending per pupil reflects differences in local costs, inputs, or needs. Consequently, the same level of spending may represent different amounts of educational resources. Disadvantaged pupils may cost more to teach if the school has to provide added support services. Each state's mix of educational resources may also vary. Some states and districts may spend more on teaching and support staff and others more on facilities. In the absence of such detailed information on inputs, per pupil spending provides only a rough measure of the relative resources devoted to education.

Table 5. Measures of Education Spending, by State and Region, 1987-88

State and region	Education as % of personal income	Spending per pupil in ADA[a]
United States	**4.4**	**$4,257**
New England	**3.8**	**5,429**
Connecticut	3.5	6,396
Maine	4.9	4,427
Massachusetts	3.6	5,466
New Hampshire	3.9	4,148
Rhode Island	4.1	5,376
Vermont	5.4	4,791
Mideast	**4.6**	**6,143**
Delaware	4.5	5,138
District of Columbia	4.0	5,643
Maryland	3.8	4,895
New Jersey	4.1	6,933
New York	5.0	6,886
Pennsylvania	4.5	5,099
Great Lakes	**4.4**	**4,155**
Illinois	3.8	4,285
Indiana	4.4	3,616
Michigan	5.0	4,306
Ohio	4.5	3,852
Wisconsin	5.0	4,948
Plains	**4.5**	**3,968**
Iowa	4.4	4,159
Kansas	4.4	4,274
Minnesota	5.0	4,390
Missouri	4.0	3,641
Nebraska	4.7	3,600
North Dakota	5.2	3,390
South Dakota	4.8	3,173
Southeast	**4.3**	**$3,572**
Alabama	3.7	2,754
Arkansas	4.9	2,618
Florida	4.0	4,353
Georgia	4.7	3,715
Kentucky	3.9	3,444
Louisiana	4.6	3,148
Mississippi	4.9	2,716
North Carolina	4.7	3,639
South Carolina	5.1	3,340
Tennessee	3.6	3,092
Virginia	4.2	4,436
West Virginia	5.8	3,693
Southwest	**5.0**	**3,622**
Arizona	5.3	3,451
New Mexico	6.0	3,880
Oklahoma	4.7	3,130
Texas	5.0	3,722
Rocky Mountain	**5.4**	**3,668**
Colorado	4.8	4,378
Idaho	4.4	2,778
Montana	6.6	4,061
Utah	5.9	2,632
Wyoming	8.9	5,503
Far West	**4.1[b]**	**4,019[c]**
California	3.9	3,916
Nevada	3.9	3,800
Oregon	5.5	4,574
Washington	4.6	4,020
Alaska	10.1	7,038
Hawaii	3.3	3,859

Sources: ACIR (1989); NEA (1989a).

[a] Average daily attendance.
[b] Includes Alaska and Hawaii.
[c] Does not include Alaska and Hawaii.

Education as a Share of Government Spending

The relationship between general spending and education spending is an index of the competing demands on a state's or locality's budget. This measure of education spending appears to be strongly related to the relative size of the student population. The New England states, with a smaller student population, devote an average of 22.8 percent of government spending to education, or nearly 1 percent less than the national average (Table 6). The Southwestern and Rocky Mountain states, with relatively more students than the national average, spend from 2 to 4 percent more of their budgets on education than the average.

States that spend a high share of their government budgets on education do not necessarily spend more, however. The Southwestern and Rocky Mountain states spend about $800 less per student than the national average.

States that spend more on education also tend to spend more on other government services. Eleven states spend more than 5 percent of personal income on education; 10 of these states spend more than 20 percent of personal income on all government services.

Table 6. State and Local Government General Spending and Education Spending, 1987

State and region	As percent of personal income: General expenditures	As percent of personal income: Elementary & secondary education	Education as percent of general spending
	%	%	%
United States	**18.7**	**4.4**	**23.7**
New England	**16.7**	**3.8**	**22.8**
Connecticut	15.0	3.5	23.3
Maine	19.6	4.9	25.0
Massachusetts	17.1	3.6	21.1
New Hampshire	14.5	3.9	26.9
Rhode Island	19.4	4.1	21.1
Vermont	21.0	5.4	25.7
Mideast	**19.5**	**4.6**	**23.6**
Delaware	20.3	4.5	22.2
District of Columbia	26.4	4.0	15.2
Maryland	16.6	3.8	22.9
New Jersey	16.4	4.1	25.0
New York	23.0	5.0	21.7
Pennsylvania	16.6	4.5	27.1
Great Lakes	**17.9**	**4.4**	**24.6**
Illinois	16.2	3.8	23.5
Indiana	16.6	4.4	26.5
Michigan	19.8	5.0	25.3
Ohio	17.5	4.5	25.7
Wisconsin	20.7	5.0	24.2
Plains	**18.5**	**4.5**	**24.3**
Iowa	18.8	4.4	23.4
Kansas	17.1	4.4	25.7
Minnesota	22.0	5.0	22.7
Missouri	15.1	4.0	26.5
Nebraska	18.0	4.7	26.1
North Dakota	23.0	5.2	22.6
South Dakota	21.6	4.8	22.2
Southeast	**17.8**	**4.3**	**24.2**
Alabama	18.4	3.7	20.1
Arkansas	17.3	4.9	28.3
Florida	16.5	4.0	24.2
Georgia	18.2	4.7	25.8
Kentucky	18.6	3.9	21.0
Louisiana	21.9	4.6	21.0
Mississippi	20.9	4.9	23.4
North Carolina	16.9	4.7	27.8
South Carolina	19.0	5.1	26.8
Tennessee	17.5	3.6	20.6
Virginia	15.9	4.2	26.4
West Virginia	21.3	5.8	27.2
Southwest	**18.3**	**5.0**	**27.3**
Arizona	21.2	5.3	25.0
New Mexico	23.9	6.0	25.1
Oklahoma	17.9	4.7	26.3
Texas	17.4	5.0	28.7
Rocky Mountain	**21.2**	**5.4**	**25.5**
Colorado	18.8	4.8	25.5
Idaho	18.5	4.4	23.8
Montana	24.1	6.6	27.4
Utah	23.4	5.9	25.2
Wyoming	33.4	8.9	26.6
Far West[a]	**19.1**	**4.1**	**21.5**
California	18.9	3.9	20.6
Nevada	19.0	3.9	20.6
Oregon	21.3	5.5	25.8
Washington	18.8	4.6	24.5
Alaska	55.1	10.1	18.3
Hawaii	19.4	3.3	17.0

Source: ACIR (1989).
[a] Far West totals do not include Alaska and Hawaii.

Thus, their relatively greater commitment to education does not appear to crowd out other government programs.

Teachers' Salaries

In most regions of the country, teachers' salaries bear the same relation to the national average as income bears to the national average (Table 7). In other words, affluent states tend to pay their teachers more. For example, in the Mideastern states, average per capita income is equal to 115 percent of the national average, and average teachers' salaries are also 115 percent of the national average. Similarly, per capita income in the Southeastern states is 88 percent of the national average, while teachers' salaries are 87 percent of the national average.

The New England region is an important exception to this rule. Average teachers' salaries in the New England states are 108 percent of the national average, while per capita income is 122 percent of the national average. The New England states also tend to exert relatively low education effort as measured by the

Table 7. Teachers' Salaries and per Capita Income, by Region and State, 1988 (as percent of national average)

Region	Teachers' salaries[a]	Per capita income	Region	Teachers' salaries[a]	Per capita income
	%	%		%	%
United States	**100**	**100**	**Southeast**	**87**	**88**
New England	**108**	**122**	Alabama	85	78
Connecticut	126	140	Arkansas	73	74
Maine	84	92	Florida	90	101
Massachusetts	107	126	Georgia	95	93
New Hampshire	90	118	Kentucky	84	78
Rhode Island	116	103	Louisiana	76	75
Vermont	91	93	Mississippi	75	67
Mideast	**115**	**115**	North Carolina	87	87
Delaware	107	107	South Carolina	85	78
District of Columbia	127	130	Tennessee	87	84
Maryland	114	118	Virginia	98	107
New Jersey	111	133	West Virginia	74	71
New York	123	117	**Southwest**	**88**	**87**
Pennsylvania	104	98	Arizona	97	91
Great Lakes	**105**	**98**	New Mexico	85	76
Illinois	106	107	Oklahoma	74	81
Indiana	97	91	Texas	90	88
Michigan	116	100	**Rocky Mountain**	**89**	**87**
Ohio	99	94	Colorado	100	100
Wisconsin	105	94	Idaho	77	77
Plains	**91**	**93**	Montana	83	78
Iowa	88	89	Utah	78	74
Kansas	93	96	Wyoming	94	83
Minnesota	107	101	**Far West**	**114**	**110**
Missouri	88	94	California	119	114
Nebraska	82	90	Nevada	98	106
North Dakota	75	78	Oregon	100	90
South Dakota	69	77	Washington	99	100
			Alaska	141	116
			Hawaii	104	102

Source: Author's calculations based on NEA (1989a) and *Survey of Current Business* (1989), Table 1.
[a] 1988-1989 school year.

share of personal income devoted to education (Table 5). A relatively small student population, resulting in a low demand for teachers, could account for these patterns.

States with high teacher salaries tend to spend more on education, but this relationship is far from uniform. Average per pupil spending is higher in Wyoming, a sparsely populated state, than in New England, where population density is high. Teachers' salaries are also higher relative to Wyoming's average per capita income. In the Far Western states, however, teachers' salaries tend to be above the national average, while per pupil spending is lower.

The preceding sections have shown that various states and regions can score very differently on alternative measures of the state and local commitment to education. Many high-effort states achieve only modest per pupil spending, while some high-spending states exert relatively less effort on education. The share of government spending devoted to education, in turn, can be high in both high- and low-spending states. Consequently, various measures of education spending are not interchangeable. Rather, they are best used together to draw a complete picture of a state or locality's commitment to education and its affordability.

State Finances and Educators' Benefits

The Employee Retirement Income Security Act (ERISA) requires extensive public disclosure of plan data by private employers, and private consulting firms publish even more information. Thus, there is extensive information that is more or less comparable for studying private plan finances.

No uniform national disclosure requirements apply to public plans, however. As a result, less information is available for assessing and comparing their financial status. The limited information that is available suggests that public plans face many of the same problems as private plans, along with some problems unique to the public setting.

This section examines the financing and management of public employee retirement and health benefits.

State Spending on Educators' Employee Benefits

States vary widely in the share of their elementary and secondary education spending devoted to educators' benefits, including a wide range of insurance, retirement, and other benefits. Data collected by the National Center for Education Statistics (NCES) of the U.S. Department of Education show that nationally 15.8 percent of education spending is devoted to benefits (Table 8). Most states spend between 47 percent (Texas and Missouri) and 140 percent (Pennsylvania) of this amount.[3]

Available data do not permit analysis of spending on specific benefits or comparison of benefits to payroll. However, some important patterns can be seen even at this highly aggregated level of observation. The share of education spending devoted to benefits does not bear a systematic relationship to the size of a state's student population or to state income (Fowler 1989). This share is related to teachers' salaries, however. Nineteen states paid teachers' salaries at or above the national average during the 1987-88 school year (Table 8). Of these states, 12 spent as much or more than the national average share of education spending on benefits. Thus, the role of benefits in education spending across states is closely related to the role of labor costs.

These data provide only a very general picture of the role of employee benefits in education spending and in educators' compensation. NCES expects to collect a more thorough and comprehensive set of figures later in 1990 that should offer an opportunity to make more detailed comparisons.

Funding Sources and Status of PERS

The maturing of the baby boom and statutory improvements in the funding and management of many public employee retirement systems (PERS) have made PERS a formidable financial force. PERS assets have nearly tripled since 1979, rising to $512.9 billion in the 1986-87 fiscal year (Table 9). To put this figure in perspective, PERS assets were three-quarters as large as all state and local government revenues collected in 1987 and about half the size of private plan assets. State-administered systems account for more than 78 percent of PERS assets and 87 percent of membership, but less than 8 percent of all plans.

The 2,414 PERS covering public employees in fiscal year 1986-87 included 10.7 million active, or working, participants and 1.1 million retired or separated participants. PERS received $99.4 billion in income in the 1986-87 fiscal year (Table 9). Over 58 percent of this inome came from earnings on investments, nearly 31 percent from government contributions, and over 11 percent from employees. PERS differ widely in how much they depend on employee contributions. Plans in 20 states received 15 percent or more of their income from employee contributions, while plans in 14 states received 10 percent or less.

The role of funding in public plans

Employees earn, or accrue, a right to future retirement benefits over the course of their employment careers. In a defined benefit plan, this accrual is offset by advance funding, or the setting aside of funds that, along with accumulated investment earnings, will cover the employee's accrued benefit by the time the employee retires. Defined contribution plans are always by definition fully funded so long as the employer, employee, or both make scheduled contributions. Sponsors of defined benefit plans, however, can use a wide range of actuarial methods for determining the rate at which their contributions should be made. The funding discussion below will thus refer to defined benefit plans only.

Funding serves several purposes in retirement plans. In private plans, funding provides the employee with the security that accrued benefits will be paid

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[3] To calculate the share of education spending accounted for by benefits in each state, multiply the national share (15.8 percent) by each state's index as shown in Table 8. Thus, for example, Texas devotes 7.4 percent of its education spending to benefits (15.8 multiplied by 0.47).

Table 8. State Spending on Educators' Employee Benefits, 1987

State	Benefits as % of education spending relative to national average[a]	Teachers' salaries as % of national average[b]
	%	%
United States	**100 (15.8%)**	**100 ($28,008)**
New England		
Connecticut	106	120
Maine	88	84
Massachusetts	58	108
New Hampshire	60	86
Rhode Island	125	117
Vermont	88	88
Mideast		
Delaware	113	106
District of Columbia	29	124
Maryland	124	110
New Jersey	78	110
New York	123	123
Pennsylvania	140	104
Great Lakes		
Illinois	94	106
Indiana	104	96
Michigan	122	118
Ohio	109	99
Wisconsin	110	104
Plains		
Iowa	78	89
Kansas	80	88
Minnesota	96	107
Missouri	47	88
Nebraska	78	81
North Dakota	86	77
South Dakota	75	71
Southeast		
Alabama	96	83
Arkansas	89	73
Florida	107	90
Georgia	128	94
Kentucky	61	87
Louisiana	101	76
Mississippi	75	73
North Carolina	98	89
South Carolina	86	87
Tennessee	102	85
Virginia	113	97
West Virginia	97	78
Southwest		
Arizona	76	98
New Mexico	82	86
Oklahoma	95	77
Texas	47	91
Rocky Mountain		
Colorado	76	102
Idaho	103	79
Montana	96	85
Utah	121	81
Wyoming	104	97
Far West		
California	111	118
Nevada	106	99
Oregon	140	100
Washington	109	101
Alaska	22	144
Hawaii	90	104

Sources: Fowler, 1989; NEA (1989a).

[a] Category includes group insurance, Social Security contributions, retirement contributions, tuition reimbursement, unemployment compensation, workmen's compensation, and other benefits such as unused sick leave payments.

[b] 1987-88 school year.

even if the employer goes out of business. Additional security—for private plans but not for PERS—is provided by employer-financed plan termination insurance provided through the Pension Benefit Guaranty Corporation (PBGC), an agency of the U.S. Department of Labor. Public employers do not generally tend to go out of business, except for consolidation, so this rationale does not apply.

Even though governments do not go out of business, the finances of PERS should be a major concern for NEA and its affiliates, as well as taxpayers everywhere. Well-funded retirement plans increase savings, providing investment capital for new jobs and growth throughout the nation. Underfunded plans, on the other hand, represent borrowing by current taxpayers from future generations and by governments from their employees. Underfunded plans transfer the costs of current benefit accruals from current taxpayers to future taxpayers, who will also face retirement benefit obligations to the teachers of their children. Underfunding also increases the cost to the employer and the taxpayers of providing promised benefits, since

Table 9. Finances of State and Local Government Retirement Systems, 1987 (dollars in billions)

State	Assets	Total receipts (Employee share)	Annual pension benefits
United States	**$512.9**	**$99.4 (11.3%)**	**$27.4**
New England			
Connecticut	5.7	1.3 (13.1)	0.40
Maine	1.2	0.4 (14.0)	0.14
Massachusetts	7.5	1.9 (20.4)	0.99
New Hampshire	0.9	0.2 (19.1)	0.03
Rhode Island	1.5	0.3 (18.8)	0.13
Vermont	0.5	0.1 (2.8)	0.03
Mideast			
Delaware	1.3	0.3 (5.7)	0.06
District of Columbia	1.1	0.3 (8.3)	0.18
Maryland	8.3	1.8 (7.2)	0.54
New Jersey	15.3	2.5 (16.0)	0.82
New York	79.0	13.4 (4.1)	4.09
Pennsylvania	20.0	4.4 (11.4)	1.57
Great Lakes			
Illinois	22.5	4.7 (16.5)	1.32
Indiana	3.8	0.9 (13.4)	0.33
Michigan	21.9	4.3 (4.2)	1.37
Ohio	30.9	6.5 (14.2)	1.84
Wisconsin	13.4	3.0 (0.5)	0.45
Plains			
Iowa	4.0	0.7 (12.5)	0.15
Kansas	3.1	0.6 (15.1)	0.15
Minnesota	10.0	1.9 (12.1)	0.45
Missouri	8.8	1.4 (11.7)	0.28
Nebraska	1.3	0.2 (19.2)	0.04
North Dakota	0.6	0.1 (18.8)	0.02
South Dakota	1.0	0.2 (14.5)	0.03
Southeast			
Alabama	6.0	1.1 (15.4)	0.26
Arkansas	3.0	0.7 (6.9)	0.11
Florida	14.5	3.3 (2.1)	0.65
Georgia	9.3	1.9 (12.6)	0.42
Kentucky	5.2	1.0 (17.9)	0.27
Louisiana	7.2	1.5 (17.7)	0.62
Mississippi	3.6	0.7 (17.4)	0.17
North Carolina	11.6	2.2 (16.1)	0.48
South Carolina	7.4	0.9 (18.5)	0.22
Tennessee	7.2	1.5 (6.8)	0.33
Virginia	8.4	2.1 (3.8)	0.35
West Virginia	1.4	0.3 (27.5)	0.16
Southwest			
Arizona	6.2	1.3 (13.9)	0.20
New Mexico	2.7	0.6 (19.7)	0.12
Oklahoma	3.9	0.9 (14.3)	0.32
Texas	23.7	4.6 (19.3)	1.10
Rocky Mountain			
Colorado	7.9	1.7 (12.8)	0.31
Idaho	1.1	0.3 (15.7)	0.07
Montana	1.2	0.3 (22.9)	0.09
Utah	0.5	0.4 (20.8)	0.08
Wyoming	1.1	0.2 (4.7)	0.03
Far West			
California	88.2	16.3 (12.3)	4.42
Nevada	2.2	0.5 (2.9)	0.09
Oregon	7.0	0.9 (17.7)	0.26
Washington	10.7	1.6 (18.7)	0.57
Alaska	3.2	0.7 (13.5)	0.12
Hawaii	2.7	0.6 (9.3)	0.17

Source: Author's calculations based on U.S. Department of Commerce (1989a).

funds that have not been set aside do not earn investment income.

It is important to note that an underfunded plan may still be solvent. As long as current contributions by employers, employees, or both cover current benefits, a retirement plan can be considered solvent. Such a plan is not funded, however. Rather, contributions made in behalf of the plan's active participants are financing the benefits of those already retired.

The funding status of public plans

NEA has conducted several surveys of PERS that include educators. Calculations based on data presented in the most recent of these surveys suggest that the typical PERS covering educators is about 69 percent funded for accrued liabilities (NEA 1989b).[4] Strictly comparable data for private plans are not available, but available information suggests that private plans tend to have lower unfunded liabilities. In 1985, 89 percent of a sample of private defined benefit plans were at least 75 percent funded, and 51

[4] The report did not indicate whether liability was measured on a current or termination basis, which measures liability as if the plan were to terminate today, or on an ongoing basis, which assumes that participants will continue accruing benefits until they retire. The former basis generally yields lower unfunded liability figures than the latter basis.

Table 10. Asset to Benefit Ratios in Selected Limited Coverage Plans

Plan	Ratio of assets to benefits	Plan	Ratio of assets to benefits
Alabama Teachers	23	North Dakota Teachers	22
Alaska Teachers	23	Ohio Teachers	17
Arkansas Teachers	25	Ohio Public School Employees	10
California Teachers	18	Oklahoma Teachers	9
Connecticut Teachers	16	Pennsylvania Public School	14
Georgia Teachers	24	Texas School Employees	20
Illinois Teachers	15	Vermont Teachers	19
Indiana Teachers	8	Washington Teachers	17
Kentucky Teachers	16	West Virginia Teachers	3
Louisiana Teachers	12		
Louisiana School Employees, non-teaching	25	Chicago Teachers	20
Maryland Teachers (old)	11	Denver School Employees	18
Massachusetts Teachers	11	Des Moines School District	24
Michigan School Employees	14	District of Columbia Teachers	7
Missouri Public School	37	Duluth Teachers	17
Montana Teachers	12	Minneapolis Teachers	14
New Jersey Teachers	20	New York City Teachers	21
New Mexico Teachers	21	Omaha Public School	27
New York Teachers	27	St. Paul Teachers	17
		St. Louis Teachers	23

Source: Author's calculations based on *State and Local Government Employee Retirement Systems, 1987.*

Note: These plans have at least $20 million in assets.

percent had funding ratios of 125 percent or more (Stevens 1989).[5]

Private plans must be funded using one of a limited group of actuarial methods permitted under ERISA. PERS are not subject to a uniform funding standard, however. In the absence of comparable actuarial data, the ratio of plan assets to annual benefit payments can be used as a rough measure of funding status. It is widely believed that PERS should maintain assets equal to at least 10 times their benefit payments to be considered at least minimally funded.

Plans whose coverage is limited to educators tend to be less well funded than general coverage plans. The Bureau of the Census collects data on state and local government employee retirement plans as part of the quinquennial Census of Governments. The Census of Governments does not provide actuarial data, but does provide plan-level data for calculating asset to benefit ratios. The most recent survey, published in 1989, covers the 1986-87 fiscal year. Out of 38 limited coverage plans for which data were available, 4 had ratios below 10 and 12 had ratios below 15 (Table 10). The average limited coverage plan had assets equal to just under 18 times its annual benefit payments in 1986-1987. In contrast, among 39 general coverage plans including both educators and other state employees, only 1 had a ratio under 10, and 5 had ratios below 15 (Table 11). The average general coverage plan had assets equal to 24 times its annual benefit payments.

Emerging Issues in PERS Management

Since more than two-thirds of PERS income comes from investment earnings or employee contributions, educators should be concerned not just with plan funding, but also with how PERS assets are managed. The management of plan assets will determine benefit security, the cost of the plan to the employer, and the likelihood of ad hoc cost-of-living increases in plans without automatic increases.

Local investments

The buildup of PERS assets over the last decade has coincided with increased budget austerity in many states and localities. Federal aid to state and local governments declined in both nominal and real terms, and state and local government tax and spending limitations became increasingly prevalent. As a result of these problems, some state and local governments have turned to PERS to supplement government

[5] Funding ratios represent the ratio of assets on hand to the plan's liabilities if it were to be terminated as of the date the ratio is calculated.

Table 11. Asset to Benefit Ratios in Selected General Coverage Plans

Plan	Ratio of assets to benefits	Plan	Ratio of assets to benefits
Alaska Public	28	Nebraska Public	42
Arizona Public	32	New Mexico State	24
Arkansas Public	42	Nevada Public	25
California Public	21	New York Public	23
Colorado Public	28	North Carolina Public	23
Connecticut Public	10	North Dakota Public	50
Delaware Public	22	Oregon Public	29
Florida Public	23	Rhode Island Public	13
Georgia Public	22	South Carolina Public	33
Hawaii Public	16	South Dakota Public	36
Idaho Public	17	Tennessee Public	24
Illinois Municipal	21	Utah Public	35
Indiana Public	24	Vermont Public	18
Iowa Public	27	Washington Public	20
Kansas Public	22	West Virginia Public	23
Kentucky Public	26	Wisconsin Public	31
Maine Public	9	Wyoming Public	35
Maryland Public (old)	10		
Mississippi Public	23	Atlanta General	13
Montana Public	15	Baltimore City	19

Source: Author's calculations based on *State and Local Government Employee Retirement Systems, 1987.*

Note: These plans have at least $20 million in assets.

Table 12. How Educators' Pension Funds Are Managed: Survey Results

Have regularly scheduled employer contributions ever been delayed, deferred, or canceled?
Yes 12 states

Has this happened since 1985? Yes 7 states

How much money was involved? $540 million

Have employer contribution formulas been reduced since 1985?
yes 15 states

Why? (Cite as many reasons as apply.)
9 Plan was overfunded.
5 Government had budget problems.
1 Benefits were changed.
3 Funding approach was changed.
3 Other reasons.

Do educators' plans practice local or social investing?
yes 17 states°

How do you rank the investment management of your plan? (0 (worst) to 5 (best))
Average score—4.2
Most commonly cited reasons:
25 states: return
9 states: management

Source: NEA Survey on Pension Plans of Public Education Employees. For responses by state, see Appendix A.

Notes: Responses are based on 79 state-administered plans in 49 states. Detail may not add to totals as not all respondents answered all questions.

° Total based on state responses as well as other information gathered for this report.

resources. PERS have played two roles in state and local finance:

- Some states and localities have encouraged the investment of PERS assets to promote state or local job growth, economic development, or other goals.
- Some states and localities have occasionally withheld or restructured pension contributions in response to budget difficulties.

PERS have come under pressure to invest assets in pursuit of various social, political, and economic goals. Some argue that PERS assets should be invested to aid local economies. Some recent examples:

- Ten states[6] agreed in 1989 to endorse a principle known as reciprocal or "Golden Rule" investing. These states agreed to invest PERS assets in each other's economies to promote growth and defend local companies against hostile takeovers.
- A California law enacted in 1988 authorizes the PERS Board to maintain up to the lesser of 1 percent of assets or $500 million in small business venture capital. The law also requires that the PERS report to the state legislature annually on the share of assets invested in California firms.

Advocates of local investing reason that a growing economy, fueled by PERS investments, will enhance the sponsoring government's ability to provide continued employment and benefits for plan participants. Such investments could reduce benefit security, however, if they result in a less diversified and riskier portfolio of assets.

Many PERS have also come under pressure to withhold investment funds from companies whose activities do not meet certain social goals. Experience with such restrictions differs across states.

A common restriction prohibits trustees from investing plan funds in stocks or bonds of firms with business ties to South Africa. The Maryland Court of Appeals recently upheld two Baltimore ordinances requiring city PERS to divest their holdings in companies doing business in South Africa even though divestiture imposed added costs and risks on the plan.[7] In contrast, the Arizona attorney general found that the State Retirement System's Investment Advisory Council was prohibited by state statutes from using strictly social or political criteria to guide investment strategy. The Council could, however, limit investments in companies doing business in South Africa if it found that such investments carried political risks and financial uncertainty for the plan.

Some funds may also direct trustees not to invest in firms with poor labor relations or to invest in firms or programs benefiting union members, such as mortgage loan programs that provide loans only for union members. New York Governor Mario Cuomo has urged state retirement systems to avoid investments in firms involved in leverged buyouts.

Local and social investing pressures raise legal as well as economic issues for both plan trustees and participants. Legal issues for PERS may be particularly complex, as PERS may be subject not only to state and local laws and legal precedents, but also to federal rules. Public plans are not subject to ERISA, which governs private retirement and other benefit plans. Nevertheless, according to Ian Lanoff, formerly the U.S. Department of Labor's pension administrator, "Courts that review activities of public plan trustees may look to ERISA for guidance." Thus, PERS trustees should be aware of the standards set for fiduciary behavior under ERISA and applicable case law (Lanoff 1989).

What the law permits, moreover, may not always be in the best economic interests of plan participants and beneficiaries. ERISA requires that plan assets be managed for the sole benefit of participants and beneficiaries, but this standard governs intent more than results. Both ERISA and state statutes based on it prescribe procedural, not performance, standards for plan fiduciaries. In other words, a plan trustee is not required to be successful in managing the assets entrusted to his or her care, but only to manage these assets with prudence.

The Maryland case and others suggest that an investment decision that reduces plan returns below what the plan could otherwise earn may nevertheless be legally proper (Korczyk 1989). A decision that benefits a plan, in turn, may be improper if procedural safeguards were not followed. Consequently, partici-

[6] Delaware, Idaho, Kentucky, Maine, Nebraska, New Mexico, North Dakota, Oklahoma, Pennsylvania, and Rhode Island.

[7] *Board of Trustees of the Employees Retirement System of the City of Baltimore v. Mayor and City Council of Baltimore City*, MD. Ct. App., Nos. 95 and 104, September 1, 1989.

pants should evaluate both local and social investing initiatives not only in political terms, but also in terms of their impact on the plan's security and participants' retirement income objectives.

Public employers have occasionally delayed, deferred, or canceled regularly scheduled contributions to PERS, usually to avoid incurring operating budget deficits. Some public employers have also reduced contribution formulas or withdrawn funds from plans to meet budget targets.

NEA survey on pension plans of public education employees

In connection with the present report, NEA undertook a brief survey of its affiliates to determine the prevalence of local and social investing and the timeliness of employer PERS contributions. The results of this survey are summarized in Table 12. The 49 state affiliates responding to the survey represented 79 state plans and 15 local plans covering educators.

The survey indicates that both issues are emerging as important policy questions in PERS covering educators. At least one in four states has used public employee retirement plan assets to meet non-retirement policy objectives.

Regularly scheduled employer contributions have been delayed, deferred, or canceled in 12 states. State and local budget difficulties appear to be accelerating in recent years. Seven states experienced these reductions since 1985. These events involved an estimated $540 million.

Employers are also reducing plan contributions through structural plan changes. Fifteen states reported that employer contribution formulas had been reduced in PERS covering educators since 1985. These reductions occurred for a number of reasons, including overfunding, government budget problems, and changes in funding approach, benefits, or interest rates.

Educators' plans in 17 states practice some form of social or local investing. The most common practice in this category was proscribing investment in companies doing business in South Africa. Economic development, housing, and venture capital investments were also cited.

The survey results only tell us what state and local governments are doing with their plans, not the impact these actions are having on the plans. More information is needed to determine which states are most likely to use retirement plan assets for non-retirement objectives and the effect such uses have on retirement benefit security.

Most NEA affiliates have a high opinion of the investment management of their plans. Asked to rank this performance on a scale of 1 to 5 with 5 being the best, 41 respondents gave their states a score of 4 or better, for an overall average of 4.2. The most frequently reported reason for a high ranking was the rate of return achieved by the plan or plans, but return was cited as a reason for several low scores as well. Many respondents were pleased by frequent evaluation and close monitoring of investment performance.

The NEA survey and Census data both suggest that most educators' plans are well managed, offering adequate security in terms of both funding and the techniques used to monitor investment performance. Two caveats must be offered to this statement. First, plans covering only educators tend to be less well funded than general coverage plans. Second, a significant minority of both types of plans are operating on a nearly pay-as-you go basis. These plans have little or no margin for adverse investment experience or local economic conditions that could prompt a surge in early retirements.

In a national or local recession, poorly funded plans could find it difficult to meet their benefit commitments and could require general revenue subsidies from their sponsoring employers. Thus, there is reason for concern about both funding and management in some educators' retirement plans.

Financing Health Care for Active Employees

As health care benefits for education employees are negotiated on the local level, state-by-state comparisons of these benefits are difficult to make. National data on health care benefits of active education employees are discussed in the first report in this volume, including premium contributions, deductibles, and limits on these benefits. These data show that many educators are well protected against the more budgetable components of health care spending but less well protected against catastrophic expenses.

Funding Issues in Retiree Health Plans

It is well known that retirees use more health care than other age groups. As employees retire earlier, live longer, and demand access to high-technology medical procedures, retiree health care is becoming increasingly expensive to provide. Furthermore, health care costs are continuing to rise faster than overall inflation, making many employers concerned over their long-term ability to meet their retiree health commitments.

Benefits are unfunded.

Most private and public plans have no funds accumulated to pay future benefits. The Employee Benefit Research Institute (EBRI) has estimated that unfunded liabilities in federal, state, and local plans totaled approximately $111 billion in 1988. If liability is proportional to the number of employees covered, the state and local share of this total would be about $95 billion.

Retiree health liabilities could add significantly to unfunded PERS liabilities. NEA data suggest that the typical PERS is 69 percent funded. Based on this estimate, unfunded pension liabilities of state and local governments could total as much as $230 billion. The EBRI estimate of retiree health obligations would add another 40 percent to this total.

Employers are terminating plans.

Neither case law nor statutory law clearly define employee rights under retiree health plans. Consequently, some employers have attempted to terminate or modify retiree benefits to contain their costs. Most litigation has involved the plans of private employers, though at least one public sector dispute has reached the courts. The city of Chicago attempted to terminate health benefits for retirees and their dependents in 1988, but reached an agreement with the annuitants and the pension funds to continue benefits for another 10 years. The city, the funds, and annuitants will pay increased costs as part of the agreement.

It is thus difficult to predict how the courts would treat plan terminations by public employers. However, cases involving private employers, particularly in collective bargaining settings, are useful in elaborating some of the legal principles at issue. Some companies have attempted to terminate retiree welfare benefits after the end of the collective bargaining agreement under which the benefits were provided. In deciding whether to permit plan termination, the courts have first looked to the language of the contract regarding postretirement benefits (Sacher and Miller 1988).

If the contract language does not clearly define the rights of the employer and the participants, courts have looked to past agreements, verbal statements and plan documents provided by the employer, and the employer's conduct. For example, an employer that continues to provide retiree benefits during a strike could be demonstrating an intent to continue providing these benefits to employees for life, even if the contract specifies, or can be construed to specify, otherwise.

The courts have also found that the nature of retiree benefits creates an implicit inference that the parties to the contract intended the benefits to continue beyond the contract's term. Once retired, an employee can no longer negotiate for improved benefits or seek other employment where these benefits may be provided. According to one authority, even a clear statement in a labor contract or plan documents that explicitly limits the duration of retiree medical benefits now may be unenforceable (Sacher and Miller 1988).

Benefits promised to active employees are changing.

Active employees should note that court cases have limited only the ability of employers to terminate benefits for employees already retired. The biggest bulge in retiree health costs is still to come when the baby boom—now age 26 to 44—retires. Nothing prevents employers from limiting the future benefits promised to active employees. For example, York County, Pennsylvania, has discontinued retiree health coverage for employees hired after January 1, 1989. Employers who continue to maintain their plans are likely to increase the retiree's share of premium costs.

Rather than terminate coverage, some employers are beginning to experiment with alternative benefit designs. The traditional plan in which the employer provides an open-ended benefit is giving way to plan design options that limit the employer's costs.

One design option being adopted by some private employers is the defined contribution retiree health plan. This option makes the employer's liability more predictable. The employer promises to make a given contribution to the retiree's coverage, whether or not this contribution covers all or even a constant share of these costs. Limiting the employer's liability makes it easier to predict and fund for it. To maintain coverage, however, retirees may have to bear large and unpredictable premium increases.

Public employers have also moved further than private employers in imposing eligibility and vesting standards for retiree health benefits like those imposed in retirement plans. In most private plans, employees are vested in the retiree health plan upon retirement from the employer, but some public plans link employer contributions to length of service. While such restrictions can limit the level of employer costs, they do not make these costs more predictable or limit their rate of increase.

New reporting requirements will prompt further changes.

Employers' efforts to restructure retiree health benefit plans could be accelerated by proposed new disclosure standards for retiree health benefits offered by public employers. On November 3, 1989, the Government Accounting Standards Board (GASB) issued a proposed statement, or exposure draft, on public employer accounting for retiree benefits other than pensions.

The proposed standard would require government employers to disclose the benefits offered; the employee groups covered; employee and employer obligations to contribute; the statutory, contractual, or other authority under which the benefits are established; and the accounting and funding policies used. Employers would also be required to disclose the expenditures and expenses for these benefits recognized for the period and related data.

The statement has been released for comments at this stage and could be modified before it becomes effective. Faced with expanded disclosure requirements, employers with large unfunded liabilities could decide to limit benefits rather than spend more or find their credit ratings impaired.

Conclusions

States vary widely in their education needs and resources as well as in their ability and willingness to spend on education. Available measures of education spending reflect a state or locality's level of effort in providing education as well as the results it is able to achieve. No one measure fully shows the resources devoted to education; all illuminate different aspects of the local decisionmaking process.

States with larger student populations need more education resources and also tend to spend more on educators' compensation. Affluent states also tend to spend more on education in absolute dollars, but not necessarily as a share of income.

High-income states tend to offer higher teacher salaries, and those with higher salaries also spend more on educators' benefits. States are facing some difficulties in providing public employees' benefits, however. Many states have underfunded retirement plans, with greater underfunding in plans covering educators only than in plans covering all public employees. Public employee plans in many states are also being used to meet non-retirement objectives. Underfunded plans threaten the security of educators' benefits and expose taxpayers to greater future costs.

Affiliates can take practical steps to evaluate their locality's economic capacity and needs. Such steps can include gathering information about their locality's tax and spending capacity and effort and using this information in negotiations.

Educators can also implement a number of steps to ensure their benefit security in the face of fiscal pressures at all government levels. State and local governments issue financial statements that disclose their employee benefit liabilities and the provision they have made for these obligations. ERISA requires private plan sponsors — but not public employers — to provide their employees with a summary annual report containing the financial information a plan sponsor must disclose to the Internal Revenue Service (IRS) each year. If a state does not require similar disclosure, educators should lobby for such information to be made available.

NEA affiliates should also evaluate the adequacy of their participants' retiree health care coverage and take steps to minimize the number of retirees who fall through the cracks of the intersecting federal, state, and local retirement income systems. Where coverage gaps exist, it is important that the sponsoring government plan for them now and set aside reserves to provide needed benefits.

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Appendix. Detailed Results of NEA Survey on Pension Plans of Public Education Employees, 1990

Regularly scheduled employer contributions have been deferred, delayed, or canceled:

Alaska
Arizona
California
Illinois
Indiana
Kentucky
Louisiana
Michigan
New Hampshire
Pennsylvania
Texas
West Virginia

This has happened since 1985:

Alaska
Arizona
California
Illinois
Kentucky
Pennsylvania
West Virginia

Employer contribution formulas have been reduced since 1985:

Alaska
Arizona
Arkansas
Colorado
Connecticut
Delaware
Kansas
New Jersey
New York
Oregon
Pennsylvania
Rhode Island
Texas
Utah
West Virginia

Educators' plans practice local or social investing:

Arizona
Arkansas
California
Connecticut
Delaware
Florida
Idaho
Kentucky
Maine
Nebraska
New Mexico
New York
North Dakota
Oklahoma
Oregon
Pennsylvania
Rhode Island

Educators' Benefits and the National Economy

While decisions about educators' compensation and benefits are fundamentally local, they are influenced by federal budget, tax, and monetary policies and by the nation's economic performance. Federal tax policy regulates tax-favored benefits and influences state and local government funding sources. Finally, federal budget and monetary policies influence the availability of funds for state and local investment as well as the economic conditions that are the ultimate test that benefits must meet.

This report examines the implications of federal policies and the national economic environment for educators' benefits. It is the third in this series of analyses examining the relationship between educators' benefits and the economy. The first report examines the major features of educators' retirement and health benefits. The second report examines the relationship among educators' compensation and benefits, education spending, and state and local government finances.

In this report the relationship between education spending and federal aid to state and local governments is examined and the effects of federal tax policy on state and local government budgets and on educators' benefits are discussed. The relationship between economic conditions and benefits planning is explored. Finally, a proposed action agenda for educators is proposed.

Federal Aid to State and Local Governments

Both educators and the education system face important unmet needs. Many state and local public employee retirement systems (PERS) are inadequately funded to meet the surge in retirements they will experience over the next 10 to 20 years. Health care costs for active employees continue to increase despite aggressive cost containment efforts. Few employers—private or public—have come to terms with their retiree health care liabilities. Added to these needs is the growing perception that U.S. spending on education will need to increase significantly. Many state and local governments face constitutional and statutory spending and revenue limits; others face limits imposed by low income and wealth.

This section examines trends in direct federal aid to state and local governments and prospects for the future. Federal aid to state and local governments accounted for nearly 11 percent of the federal budget in 1989. Federal aid grew throughout the 1980s despite the restructuring of fiscal federalism that places more responsibility on state and local governments. Nevertheless, federal aid accounts for a declining share of state and local spending.

Has federal policy left states and localities strapped with demands they cannot meet, or are states and localities doing perfectly well despite declining federal aid? Some answers can be found by examining patterns of federal aid, both for elementary and secondary education and for other purposes, over the last three decades. Money is inherently "fungible," or substitutable; an increase in outside funds for one function can enable a locality to spend more of its own-source revenues on other functions. Education can thus benefit not only from grants specifically designated for it, but also from general-purpose aid and even aid earmarked for other functions.

Federal aid to state and local governments grew from $7.0 billion in 1960 to $115.3 billion in 1988 (Table 1). This growth was more than four times as rapid as inflation over this period and 76 percent higher than the growth of GNP. Federal aid for education also grew rapidly over this period, increasing from $400 million in 1960 to $9.4 billion in 1988.

Federal aid has not grown evenly over this period, however. During the 1960s, federal aid for all purposes grew by $17.0 billion (calculations based on Table 1). The 1970s recorded an increase of $67.5 billion, but growth dropped to $23.8 billion during the 1980s. After adjusting for inflation, federal aid actually declined during the 1980s. Education grants have also displayed swings, although, because of their smaller absolute size, these swings have not been as extreme.

Some analysts thus argue that the federal government has not been a reliable partner in its relationships with state and local governments. Large and frequent changes in aid can disrupt state and local planning, weakening program effectiveness.

The impact of changes in federal grants on state and local spending can be measured in an approximate way using the changing fraction of state and local spending accounted for by grants. This share is independent of inflation, since changes in price levels affect the purchasing power of grants and state and local spending equally.

State and local spending has more than made up for the real, or inflation-adjusted, decline in federal aid. Federal aid declined as a share of state and local spending by more than 40 percent during the 1980s (Table 1). Federal aid for education, which has never been a large share of state and local spending, displayed a similar decline.

The declining role of federal aid in state and local spending suggests that many states and localities are becoming less dependent on federal aid. With a stable federal presence, however, state and local spending could have grown more, and more state and local services could have been provided.

Federal Tax Policy and Educators' Benefits

Federal tax policy affects education spending and educators' compensation and benefits in two ways:

- Federal tax laws influence state and local government spending, taxes, and borrowing.
- Federal tax laws determine the structure and tax treatment of tax-favored benefits.

Federal Tax Policy and State and Local Budgets

State and local taxes function much like private-market prices for government services and for the right

Table 1. Federal Grants and State and Local Finance (dollars in billions)

Year	Federal grants		Grants as a % of state and local spending	
	All	Education[a]	All grants	Education only
			%	%
1960	$ 7.0	$0.4	14.0	0.8
1965	10.9	0.7	14.4	0.9
1970	24.0	3.0	17.9	2.3
1975	49.8	4.9	21.2	2.1
1980	91.5	7.6	25.2	2.1
1981	94.8	7.7	24.2	2.0
1982	88.2	7.1	21.3	1.7
1983	92.5	6.7	21.0	1.5
1984	97.6	7.3	20.5	1.5
1985	105.9	7.9	20.5	1.5
1986	112.4	8.7	20.0	1.5
1987	108.4	8.6	18.0	1.4
1988	115.3	9.4	17.8[b]	1.5[b]

Source: Author's calculations based on Executive Office of the President, *Budget of the U.S. Government: Historical Tables*, and ACIR (1989)

[a] Elementary and secondary education.

[b] Estimated by author.

to live in certain locations. Even in a single metropolitan area, taxpayers can often choose among high- and low-tax jurisdictions, with corresponding differences in the state and local government services available.

State and local taxpayers are believed to view their tax liability net of federal tax deductions when they vote on state and local spending or decide where to live (Kenyon 1986). This effect was reduced by the Tax Reform Act of 1986. Sales taxes are no longer deductible; most taxpayers fall in the 15 percent tax bracket, reducing the value of itemized deductions; and fewer taxpayers are itemizing deductions. These provisions could reduce state and local spending, taxes, and borrowing.

The federal deductibility of state and local taxes reduces the perceived cost of state and local services for those taxpayers who itemize their deductions. Consider a taxpayer, for example, who faces a maximum state income tax bracket of 10 percent and pays at the 28 percent federal tax rate. Since state income taxes are deductible, this taxpayer's effective marginal state rate is 7.2 percent.

Deductibility encourages state and local governments to make greater use of deductible taxes. The 1986 law could affect state and local revenue mix in one of two ways. Eliminating the deductibility of sales taxes could reduce sales tax use and encourage greater use of deductible taxes. For example, Texas is reportedly beginning to consider the implementation of an income tax. Counteracting this effect, however, will be the reduced value of deductibility, which could discourage state and local use of taxes in general and encourage greater use of such nontax revenues as user fees.

The reduction of the maximum federal marginal tax rate from 50 percent to 28 percent could also increase state and local government borrowing costs. With lower marginal tax rates, a tax-exempt rate of return on state and local bonds will be worth less compared with the return on a taxable bond. With higher borrowing costs, state and local governments may have to cut back their building plans and pay more for the facilities they do build.

At the same time, however, the 1986 law did away with a large number of tax shelters formerly available to high-income taxpayers. With fewer alternatives, many investors will find state and local securities attractive investments. In addition, low inflation and easy monetary policy may offset any adverse effects of federal tax policy on state and local borrowing costs.

Federal Tax Policy and Employee Benefits

The federal income tax code is the most important influence on the design and availability of employee benefits. The federal income tax laws have fostered the growth and development of certain employer-provided benefits. Employer contributions for health care coverage and certain other employee benefits are tax-deductible to the private employer and excluded from the federal personal income tax base. Pension contributions to qualified plans are also deductible to the employer and, along with accumulated investment earnings, are not included in the tax base until received as benefits.

Unlike private employers, public employers do not need tax deductions for their benefit contributions. Like private employees, however, public employees rely on tax exclusions for employer contributions. The tax exclusion and deferral for employer contributions to benefits became more valuable to employees as inflation pushed taxpayers into higher tax brackets over the 20-year period preceding the 1986 law. An estimated 20 percent of the growth of benefits in compensation over that period was due to rising marginal tax rates and the resulting increase in the attractiveness of benefits as compensation (Korczyk 1984).

The Congressional Budget Act of 1974 requires that a list of tax expenditures be included in the President's annual budget submission to Congress. Tax expenditures are defined as tax revenues lost to the federal government as a result of special exclusions, exemptions, or deductions from gross income, special credits, preferential tax rates, or deferrals of tax liability. Tax expenditures resulting from the tax treatment of employer-provided health and retirement benefits are now estimated at nearly $81 billion annually. Nearly two-thirds of this total is represented by taxes deferred on pension contributions and investment earnings (net of taxes paid on benefits as received by annuitants).

As tax expenditures for benefits have grown, federal tax policy has become increasingly concerned with two goals:

- ensuring that employers with plans make benefits widely available to their employees; and
- limiting the revenue losses associated with the growing attractiveness of employee benefit plans.

Ensuring availability of benefits

Employers are not required to offer retirement or health care plans. Once they do so, however, they must observe certain rules designed to ensure that these tax incentives are cost-effective from a social standpoint. Cost effectiveness means that coverage must be nondiscriminatory, or available broadly throughout an employer's work force, and that benefits must be comparable relative to pay at all pay levels. Different nondiscrimination rules apply to retirement and to health plans.

Retirement plans

As a condition of favorable tax treatment, or qualification, employer-provided retirement plans must meet certain design and availability rules. Some of the same rules that apply to private plans also apply to public plans, though often in modified form (Pacelli 1989). These rules include the following provisions:

- coverage rules (form prevailing prior to Employee Retirement Income Security Act of 1974 [ERISA])
- participation rules
- limits on the annual pay per employee that can be covered by the plan's benefit formula
- general nondiscrimination rules that govern the level of benefits relative to pay available to highly compensated and rank-and-file employees
- integration rules that govern the degree to which Social Security contributions and benefits can be taken into account in determining plan contributions and benefits
- minimum distribution rules that govern when employees must receive benefits
- certain rules governing actuarial assumptions

In theory, these rules have long applied to PERS. In practice, the IRS has, since 1977, observed a moratorium on disqualifying PERS for violating these rules. In a disqualified plan, employees would become liable for taxes on employer contributions and investment earnings. Disqualification thus removes the tax advantages of qualified plans.

As part of the proposed minimum coverage regulations issued in May 1989, the IRS announced that governmental plans must satisfy the applicable nondiscrimination rules beginning with the 1989 plan year.[1] Sponsors of public plans that are not tax-qualified could seek to manage these plans on an unfunded basis to avoid adverse tax consequences for employees. Such steps could impair benefit security in many PERS.

Health care plans

Availability rules for employer-sponsored health care plans have been extensively debated in recent years. Prior to the 1986 tax reform act, employer-provided health care coverage and other non-pension benefits were subject to widely differing nondiscrimination rules. In the 1986 act, Section 89 was added to the tax code. This section imposed revised, expanded, and standardized rules, as well as qualification requirements on health and other plans of public and private employers. Highly compensated employees in discriminatory plans were to include a portion of the value of employer-provided benefits in income.

Section 89 was repealed late in 1989; the pre-1986 rules are once again effective. These rules do not cover health care coverage plans financed by employer purchases of insurance or other coverage. This exclusion is based on the assumption that the insurer's interest in achieving an adequate-sized risk pool would encourage broad coverage within an employer's work force.

Nondiscrimination rules are provided under the tax code for employers with self-insured health care coverage plans. An employer who self-insures undertakes to cover health care claims incurred by employees out of its own revenues.[2] Fewer than 20 percent of public employees are covered under self-insured plans according to the Bureau of Labor Statistics, compared with just over one-third of private employees. Most employees with health care coverage are thus in plans that are not subject to nondiscrimination rules.

Limiting federal revenue losses

In addition to ensuring broad coverage and nondiscriminatory benefits, policymakers have also been concerned with limiting federal revenue losses resulting from the growth of benefits. In theory, all revenue losses could be wiped out by simply revising the tax code to include in employees' income all employer

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[1] For Section 403(b) annuity plans, the applicable rules are those enacted in the 1986 tax reform act. For all other plans the rules are those provided in the tax code before ERISA. The deadline has since been extended to 1993.

[2] Self-insured employers generally purchase stop-loss coverage from an insurer to cover extraordinary claims.

contributions for benefits that currently receive tax preferences. Some advocate this approach because it would eliminate government interference in the choice between benefits and cash compensation. If employers gave employees cash instead of benefit contributions, employees themselves would be able to decide how much health and retirement protection they want.

Others argue that tax incentives for employee benefits accomplish important social goals. Calls for implementing a national health insurance program have become muted in recent years as the employer health system has come to enroll a majority of the nonelderly population. Similarly, employer-provided retirement benefits supplement Social Security benefits in achieving appropriate retirement income replacement rates and increasing national saving. Efforts to limit federal revenue losses have thus had to be balanced—not always successfully, many would argue—with the need to maintain adequate incentives to encourage employer plans.

With the repeal of Section 89, as well as continued federal deficits, many observers expect renewed efforts to limit revenue losses in both retirement and health plans. Two major retirement plan limits and one health plan limit are expected to be discussed in the current congressional session, though none is a clear candidate for enactment.

Limits on retirement plans

S. 1654, introduced by Sen. Robert Dole (R-KS) and Sen. Nancy Kassebaum (R-KS), would impose an excise tax on the gains from the sale of assets held by pension plans for 180 days or less. The bill reportedly stems from policymakers' concerns over the role of pension plans in corporate takeovers and leveraged buyouts, as well as the short-term investment perspective of both plan sponsors and pension investment managers. Proponents of this legislation argue that pension funds, with their long-term liabilities, should have a correspondingly long-term investment focus.

S. 1654 raises important policy questions. There is some evidence that stock held in private pension plans displays higher turnover rates—more active buying and selling—than the stock market as a whole. There is also evidence that private plans with higher turnover rates earn lower rates of return than plans that tend to hold their assets for longer periods of time (McCarthy and Turner 1989). This evidence suggests that higher turnover is not benefiting the plans. High-turnover plans should earn higher rates of return than low-turnover plans to justify their higher trading costs.

High investment turnover arguably benefits plan managers at the expense of employers, participants, and beneficiaries. At the same time, however, too little is known about what determines the investment success of a pension plan to warrant the imposition of rigid guidelines. Furthermore, some observers fear that taxing short-term gains of retirement plans could be an opening wedge in the erosion of the tax deferral currently accorded to qualified plans.

As an alternative to directly taxing plan assets, some advocate another reduction in the limits on benefits and contributions in qualified plans imposed under Section 415 of the Internal Revenue Code. In defined benefit plans, benefits are limited to the lesser of 100 percent of compensation in the participant's three highest-earning years or $108,400 (projected for 1991). In defined contribution plans, the sum of contributions and forfeitures credited to the employee's account may not exceed the lesser of 25 percent of compensation or $30,000, the latter limit to be indexed for inflation once the defined benefit plan limit reaches $120,000. For an employee covered by more than one qualified plan, the limits are the lesser of 125 percent of the combined dollar limits or 140 percent of wages.

The Congressional Budget Office (CBO) has suggested that the defined benefit limit could be reduced to the payroll tax wage base, projected at $54,600 for 1991 (CBO 1990). Equivalent reductions would be enacted in defined contribution plans and salary reduction plans, including tax-sheltered annuities.

The CBO argues that these limits provide for future benefits higher than the current wages of many active employees. However, Section 415 limits are also used to determine an employer's long-term funding plan. Over a full working career, even funding for benefits of moderate income employees could be restricted by reducing Section 415 limits. Such reductions could thus impair the funding status of many plans.

Limits on health care plans

Some believe that the rise in health care costs is due in part to the open-ended tax benefits accorded employer-provided coverage. In this view, these tax benefits encourage employers to offer generous health care coverage and remove the incentive for employees to economize on health care use.

To limit these tax benefits and encourage more economical use of health care, some researchers and legislators have proposed limiting the exclusion for

health care coverage. Such a proposal was considered in the debates over the 1986 tax reform law. The CBO has suggested limiting the exclusion for employer-paid health coverage by treating as taxable income for employees any employer contributions that exceed $250 per month for family coverage and $100 a month for individual coverage, indexed for inflation. This proposal would affect about 50 percent of individual income tax filing units (CBO 1990).

Capping the amount of employer-paid insurance excluded from income for tax purposes would still permit a higher tax benefit for employees with employer-financed coverage than for those who must pay the entire cost of employer-provided coverage or who buy individual coverage. To provide comparable treatment for these groups, the entire value of employer-paid health insurance premiums could be treated as taxable, with an individual income tax credit of 20 percent for health insurance premiums up to the limits above. The credit would be available whether the coverage was paid for by an employer or individually by the employee. Under this option, the tax subsidy for employer- and employee-paid coverage would be equivalent.

This option is often paired with efforts to expand health care coverage. Despite current tax incentives for health care coverage, an estimated 31 million people lack health care coverage. About half of these people are either steadily employed or dependents of steady workers (Chollet 1988). Since their employers apparently cannot afford to offer coverage despite these incentives, expanding coverage among this group could require increased federal subsidies. Some argue that coverage expansion should be paid for through increased taxes on employees with coverage.

Limiting employer-provided health care coverage will remain attractive to policymakers from a revenue-raising standpoint. The potential effects of such limits on health care use and medical cost inflation are uncertain, however. Employers are introducing numerous cost containment features into their health care plans even without federal encouragement.

Effects on public plans

PERS and public employee health care plans could face important consequences from federal efforts to reduce discrimination, expand coverage, and reduce federal revenue losses in employee benefit plans.

Public plans generally cover most of the employer's work force, eliminating concerns that employees could be excluded from coverage in a way that discriminates against lower-paid employees. In some public plans, however, elected officials or political appointees are eligible for benefits on more generous terms than are available to other employees.

To avoid a discriminatory benefit structure, public plans could segregate the discriminatory portion of benefits. In retirement plans, benefits in excess of those allowed under qualified plan rules could be offered on a nonqualified basis. Employers generally may not fund for such benefits or secure them without exposing the participant to current tax liability, however. Consequently, this portion of benefits would have to be structured as an unsecured promise to pay benefits. In self-insured health care plans with discriminatory benefits, employers are required to include the discriminatory portion of benefits—the share not available to rank-and-file employees—in employees' income.

Efforts to limit federal revenue losses could affect rank-and-file PERS participants as well. Many PERS are less well funded than private plans. Taxing short-term gains could reduce these plans' ability to improve their funding position. On the other hand, federal tax penalties might not be able to reach PERS as easily as they can reach employees or private plans.

Capping the tax exclusion for health care coverage would affect educators and other public employees. Public plans offer relatively generous "front-end" benefits; public employees are less likely to contribute to the cost of their plans and tend to face lower deductibles than private employees. Such provisions tend to increase the cost of coverage. If a cap were enacted, educators would have to choose between added tax liability and higher health care costs. Capping the health care exclusion could also make it more difficult for educators to achieve needed benefit improvements, such as limits on out-of-pocket expenses and removal of lifetime benefit limits.

The special case of retiree health plans

The Government Accounting Standards Board (GASB) has proposed expanded reporting and disclosure requirements for public employers' unfunded retiree health care liabilities.[1] These unfunded liabilities could adversely affect employers' financial statements and credit ratings.

Retiree health care plans remain largely unfunded because employers have limited options for funding

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[1] See discussion above under "Educators' Benefits and State Economies."

these benefits on a tax-preferred basis. Without tax preferences, employer contributions to fund these plans would be currently taxable to employees. The Deficit Reduction Act of 1984 (DEFRA) imposed restrictions on employers' ability to set aside funds for retiree health care in a voluntary employee benefit association (VEBA).

Employers may set up trusts under Section 401(h) of the Internal Revenue Code to fund retiree health benefits in conjunction with a qualified retirement plan. These trusts also face limits, however. Contributions must be no larger than 25 percent of the total contributions to the plan. In addition, contributions to Section 401(h) trusts are counted against the statutory limits on pension contributions and benefits. As a result, incorporating these benefits in a qualified plan could reduce available retirement benefits for some highly paid employees.

Section 105(h) medical savings accounts constitute another way to provide for retiree health benefits under current law. Such accounts may be funded by the employer and used by the employee to cover many medical expenses not covered by the employer's core health plan. Unused balances may be rolled over from year to year. The employee would forfeit the unused balance if he or she terminates employment for reasons other than retirement, disability, or death, however. The Section 105(h) account could be a way to encourage employees to save for catastrophic health expenses or postretirement health care.

Employers are unlikely to reduce their unfunded retiree health liabilities without expanded tax-preferred funding options, while the enactment of such options is unlikely unless employers take some action to define and limit their liabilities. Congress is unlikely to expand tax benefits for retiree health plans unless these plans are subject to coverage, vesting, participation, and other standards, much like qualified plans. Such standards would make employer liabilities more predictable and limit the revenue losses that would be associated with expanded and improved funding vehicles.

Emerging concerns over long-term care

As the elderly population grows, increasing numbers of people will need nursing home care or other assistance with daily living activities in their own homes. Nursing home costs commonly range from $1500 to $3500 monthly. Medicare pays for up to 180 days of care for some patients. Most patients must use private resources, becoming eligible for Medicaid when their savings are exhausted.

The increased concern over long-term care needs is fostering the development of insurance products and employee benefits covering such care. The Employee Benefit Research Institute estimates that more than 100 insurers currently sell coverage for long-term care, and at least 35 employers offer access to coverage as an employee benefit (Friedland 1990).

Like retiree health care coverage, however, long-term care insurance faces a number of uncertainties. Costs and liabilities are difficult to predict, since long-term care includes not only medical benefits but also ordinary living expenses. The tax treatment of coverage offered as an employee benefit is also not clear. As the population ages, there will be increasing interest in the design and tax treatment of this benefit.

Economic Conditions and the Adequacy of Benefits

Predicting long-term inflation, interest rates, and national, state, and local employment and growth with confidence and accuracy is a difficult task. Nevertheless, such forecasts are an integral part of benefit planning, particularly for retirement plans.

The economy's performance plays three major roles in the management of retirement plans. First, the economy determines the investment performance of retirement plans. Educators need to monitor their plans' investment performance to determine whether it adequately reflects the performance of financial markets. In this task, educators need to be concerned not only with the level of a plan's investment return, but also with its variability. Risky investments, such as "junk" bonds, can increase short-term returns, but often at the considerable risk of capital values. A plan whose returns are highly variable can become a drain on the employer's treasury and a potential sacrifice to short-term budget objectives.

Second, the economy's overall performance need to be reflected in the actuarial assumptions governing educators' retirement plans. The costs of retirement plans are largely driven by the benefits offered and by demographic patterns in the employer's work force. Actuaries predict future inflation, wage and price growth, work force turnover, and mortality to advise employers about how to fund defined benefit plans. Plan design and income replacement targets for both defined benefit and defined contribution plans should also reflect long-term forecasts of national and local economic performance.

Actuarial forecasts are not like economic forecasts, however. Economic forecasts are intended to

predict short-term events. Actuaries, on the other hand, must devise plan assumptions that are reasonable in the aggregate and over the long term. The assumptions about external conditions and the behavior of the plan population must be internally consistent, but they will not generally reflect economic performance in any one year.

Thus, high market interest rates in any one year or even several years should generally not result in raising plan interest rate assumptions. The higher a plan's assumed interest rate, the lower the amount of assets it needs on hand to fund a projected stream of liabilities. If long-term interest rates are lower than short-term experience, a plan using an optimistically high interest rate for funding will be underfunded when its retirement liabilities come due. Assumptions about inflation, wage and productivity increases, and labor force behavior should also reflect long-term performance.

To determine whether a plan is on an acceptable long-term funding path, periodic actuarial valuations by independent professionals are essential. ERISA requires that private plans undergo periodic actuarial valuations, but there are no uniform requirements for public plans.

Finally, the economy's performance determines whether employee benefits perform the function for which they were designed. Changes in prices, taxes, and economic conditions can reduce the purchasing power of promised benefits. Educators need to be concerned with political leadership and understand how economic policies can influence the value of their benefits.

The adequacy of health benefits for both active employees and retirees will also depend on employers' ability to forecast and provide for increases in costs and medical needs. Health plan costs reflect the same factors as retirement plan costs as well as many others that might be beyond the employer's ability to control or predict. These factors can include medical care inflation, advances in medical technology and treatment, and changing health care use patterns among employees and retirees. Efforts by hospitals and other providers to recoup unreimbursed health care expenses—such as those incurred in behalf of the uninsured—from those with health care coverage can also increase health care costs.

Since 1988, both public and private plans have experienced annual increases of 15 to 20 percent in the average cost of their plans (Mackin 1989; Wyatt 1988; Foster Higgins 1988). Public employers will need to cover these increases through increased public appropriations, higher employee contributions, or both.

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Employee Benefits for Educators: An Action Agenda

The reports in this series have evaluated the adequacy of educators' retirement and health benefits, the economic conditions affecting state and local government decisions about these benefits, and the economic environment in which educators must live with these decisions. This section summarizes the policy implications of this analysis.

Educators' Needs and Their Benefits

Educators' benefits generally meet the standards of private sector benefits. Measured by the standard of educators' needs, however, retirement and health benefits display certain important gaps. In the case of health benefits, limits on benefits provided and gaps in retiree health care coverage can cause hardship. In the case of retirement benefits, inadequate inflation protection can cause hardship for early retirees with low or moderate career earnings. Among educators without Social Security coverage, income replacement rates may make other employment a necessity, either before or after retirement from the education profession.

Paying for Benefits

State and local government finances determine how much localities are willing to spend on education and educators' compensation and benefits and the long-term security of the benefit commitment. In negotiating benefit improvements, affiliates need to understand the economic capacity of their employers.

- Tax capacity and tax effort can be used to measure how much localities can afford and are willing to pay for education and for educators' compensation and benefits.
- Education spending, education effort, and educators' salaries and benefits all measure different aspects of community decisionmaking about education. These measures can be used together to evaluate localities' education needs and the resources they have to meet these and other public needs.

NEA survey results show that many states and localities use their employees' retirement benefit funds both for short-term operating funds and for investment capital. Such practices, along with low funding ratios in many plans, suggest that the security of some educators' retirement benefits is being subordinated to non-retirement social goals.

- Affiliates need to monitor the financing and management of their retirement plans closely.

Health care costs for active employees are increasing as medical technology advances and increases patients' expectations. These costs pose complicated problems for all employers.

- As health care costs increase, affiliates need to monitor the design of their health plans to ensure that the benefits they need remain available. Improvements should focus on benefits for catastrophic expenses.

Retiree health benefits are generally not funded at all. If private sector experience is a guide, these benefits will become increasingly vulnerable to limits and elimination as state and local governments are forced to measure and disclose these costs.

- Affiliates need to review their retiree health coverage to identify both gaps and ways to improve benefit security.

Educators' Benefits and the National Economy

Federal budget policy influences benefit affordability in several ways. Federal aid to state and local governments, for education as well as for other functions, influences what state and local governments can afford to spend. This aid has declined significantly as a share of state and local spending during the 1980s. Federal policy has also increased the cost of raising funds for state and local governments through lower marginal tax rates, reduced deductibility of state and local taxes, and increased restrictions on state and local borrowing.

Faced with high budget deficits, federal policymakers will continue to monitor the cost-effectiveness of tax incentives for employee benefits and attempt to contain the resulting revenue losses. Taxing at least a share of employee benefits will continue to be discussed as a policy option, though this option is controversial.

- Affiliates should oppose proposals that short-term retirement plan investment gains be taxed, since many educators' plans are underfunded.
- Taxing a share of health benefits, in turn, could make it more difficult to implement certain needed benefit improvements in educators' plans, including broader retiree coverage and improved protection against catastrophic health costs.

Public employees and their employers negotiate their benefits and live with the results against the background of the nation's economic performance. The level and affordability of employee benefits for state and local employees reflect federal aid to state and local governments, federal tax and budget policy, and the national economy's performance.

Affiliates thus need to evaluate the national economic environment in making benefits choices. In evaluating their benefit security, educators need to understand the proper use of economic forecasts. Retirement plan performance should reflect the overall performance of financial markets. Short-term economic performance should not be used to determine plan actuarial assumptions, however. Retirement plans accumulate assets and pay benefits over as many as 60 years of a participant's lifetime. The plan's actuarial assumptions should reflect the length of the benefit commitment.

- The actuarial assumptions used to accumulate retirement plan assets should reflect the long-term prospects of both the plan's participants and the nation's economy.

Decisions about the adequacy and affordability of educators' benefits cannot be made once and then forgotten. Rather, they must continuously be made and reaffirmed. Monitoring economic trends will help educators in this task.

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